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ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

ALEXANDER'S FEDERAL TAX HANDBOOK

1955 EDITION

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How to minimize taxes on transfers to controlled corporations under 1954 Code

by CHARLES S. LOWRIMORE, SR.

The new Code generally makes transfers to controlled corporations easier and more certain taxwise. The thin-corporation problem still exists, the definition of "securities" is unsettled, and business purpose is still as important as ever. This article analyzes all these matters, including basis questions, and quotes pertinent passages of the new Code and committee reports, all for the purpose of bringing together a comprehensive picture of tax consequences of transfers to corporations owned by the transferor

THE IMPORTANT CHANGES contained in the new law with respect to transfers to a corporation controlled by the transferor are as follows:

1. The requirement for the proportionate interest test with respect to two or more persons in a 112(b)(5) exchange has been eliminated in Section 351 of the new Code. Stock and securities may be issued in any proportion to two or more persons under the new law.

2. A taxable event with respect to a gift, payment for services and in satisfaction of a liability may arise out of transferors receiving stock and securities disproportionately in a Section 351 exchange.

3. If stock and securities are received in a Section 351 exchange by a person or persons for services, such services shall not be considered as property transferred in the exchange and the value of such services will be taxable to the recipient of such stock and securities at their fair market value, and as ordinary income.

4. If the purpose of transferring a liability or liabilities is to avoid the payment of the income tax, or if such transfer of the liability or liabilities does not have a business purpose, then the total amount of such liabilities transferred shall be considered as money received in the exchange; in prior law only a particular liability was so considered.

5. Distribution to shareholders of a transferor corporation of the stock and securities received by the transferor corporation in a Section 351 exchange will not prevent the application of 351.

6. Where a transferor has transferred liabilities in excess of the adjusted basis of the assets transferred in a Section 351 exchange, the transferor will be taxed on such excess under the appropriate section of the law dealing with the class of the assets transferred.

7. Treatment of dividends received as Section 306 stock, which is defined in Section 306(c), which in general is preferred stock issued as a stock dividend.

8. Special rule relating to contributions to capital and the basis in the hands of the corporation of such contributions.

General rule

Under the general rule, Section 351(a), no gain or loss will be recognized in an exchange transaction, if property is transferred by one or more persons (transferor or transferors) to a corporation and the transferee corporation issues its stock or securities to the transferor or transferors in exchange for such property, and immediately after the transfer the transferor or transferors are in control of the transferee corporation.

The language of the 1954 Code, Section 351(a) reads this way: "(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property."

Under the old law the transfer by one person of property in exchange for stock or securities in a Section 112(b)(5) transaction was simple, but if the

property was transferred by two or more persons the old law provided that: "this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." This requirement of the old law complicated compliance and was the cause for considerable uncertainty in its application. The requirement for the proportionate interest test under the old law has been eliminated in the new law. The Senate Committee Report, page 264 says: "In eliminating the proportionate interest test, your committee intends that no gain or loss will be recognized to a transferor transferring property to a corporation under Section 351, irrespective of any disproportion of the amount of stock or securities received by him as a result of the transfer. Thus, if M and N each owning property having a value of $100 transfer such property to a newly formed corporation X, and M receives all of the stock, such transaction would not be subject to tax under Section 351."

In the example contained in the Senate Committee Report reference is made only to stock; it is my opinion, however, based upon subsequent explanations by the Committee with respect to disproportionate receipt of stock and securities, that the intention was to include securities.

Result of disproportionate receipt of stock, securities

The Senate Committee Report says: "To the extent, however, that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this Code, your committee intends that such distribution will be taxed in accordance with its true nature. For example, if individuals A and B, father and son, organize a corporation with 100 shares of common stock and A transfers property worth $80 to the corporation in exchange for 20 shares of stock, while B transfers property worth $20 to the corporation in exchange for 80 shares of stock, no gain or loss will be recognized under Section 351. If, however, it is determined that in fact A has made a gift to B, it is your committee's intention that such gift would be subject to tax under the provisions of Section 2501 and following. Similarly, if, in the preceding example, B had rendered services to A and the disproportion in the amount of stock received constituted, in effect, the payment of compensation by A to B, it is your committee's intention that such compensation will be appropriately taxed. B will be taxable upon the fair market value of the 60 shares of stock received in excess of that received in exchange for his property as an amount received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis of the 60 shares of stock in his hands and its fair market value.

"In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind."

The Senate Committee Report makes it clear that the stock or securities in a Section 351 exchange may be issued in any ratio, to the transferors, regardless of the interest each of the transferors may have owned in the property prior to the exchange. Similarly, it appears that the stock or securities issued to each of the transferors is considered to have been issued in a bona fide exchange for value, and for this reason, if there is a difference of proportion with respect to the determined values, then a question arises as to whether or not there may be a gift, a payment of compensation, or a payment in satisfaction of a liability.

EXAMPLE 1: Two individuals own an equal interest in a partnership and under Section 351 transfer the assets to a corporation. The total partnership assets, less the liabilities, amount to $100,000, representing the net equity of the transferors. Each of the two individuals receive $50,000 in stock or (and) securities. Under these circumstances the exchange would be tax free under Section 351.

However, if the two partners, in Example 1, were father and son and prior to the exchange the capital accounts of the partnership showed that the father had a credit of $75,000 and the son a credit of $25,000, the law would consider that the father had received $75,000 and the son had received $25,000 in the exchange. If it was determined from the facts that the father had no obligation to his son for the payment of compensation or no obligation for the repayment of a debt, then, in my opinion, the difference of $25,000 would be considered as a gift from the father to the son. The $25,000 if determined to be a gift would be subject to the provisions of Code Section 2501.

The reference to proportions is with respect to the amounts received by the transferors and in no way relates to the ratio of stock as invested or equity capital in proportion to the issuance of securities as debt or borrowed capital.

EXAMPLE 2: Two individuals have formed a partnership and operated over a period of years under an agreement which provides that the dissolution of the partnership would result in a division in accordance with the credit to the capital account of each at the date of dissolution. However, because of the desired retirement from active participation in the affairs of the partnership by the senior member of the partnership, it has been verbally agreed that the junior partners would receive as compensation some amount to be agreed upon at the date of settlement. The two partners agree that it is in the best interests of the business and for the best interests of the families of the

partners that a corporation be formed for the purpose of carrying on the business. The corporation is formed and the assets and liabilities of the partnership are transferred to the corporation. The capital account of partner A (who desires to retire) shows a credit of $100,000, while the capital account of partner B who will continue to manage the business after incorporation shows a credit of $50,000, a total net equity of $150,000. The corporation issues its stock and securities in exchange for the net assets in the amount of $150,000 to the two partners, and under these circumstances the exchange has qualified under Section 351 as a non-taxable exchange. Partner A receives stock and securities in the amount of $75,000 and partner B receives stock and securities in the amount of $75,000. Under these circumstances it is my opinion that partner B has in fact received compensation in the amount of $25,000, assuming that the transfer values are the fair market values, and that the amount of $25,000 would be taxable to partner B (under the provisions of the Code) as ordinary income. Again assuming that the transfer values are the fair market values, partner A would realize a deductible loss of $25,000, since his basis for the partnership interest was $100,000 and he receives only $75,000 of fair market value in the exchange.

One or more persons

The term "one or more persons" as used in Section 351 includes individuals, trusts, estates, partnerships, and corporations. For purposes of definitions of the included classifications, see Section 7701. Since the old Regulations 118, 39.112(b)(5)-1 are consistent with the new law, with respect to the meaning of the phrase "one or more persons" they are effective.

Stock or securities

The term "stock or securities" is extensively used in the organization and reorganization sections of the Code. The Senate Committee Report uses the term interchangeably with the term "stock and securities," it therefore appears that the intent was to allow the transferors in a Section 351 exchange to receive either stock or securities, or to receive both stock and securities. However, if there is only one person as a transferor, such person would be compelled to receive in the exchange either all stock or stock and securities. Under these circumstances the transferor could not receive stock or securities; in other words the transferor could not take securities without the taking of stock.

The word "stock" is universally understood to mean the shares of stock owned as a part of the equity capital of the issuing corporation, and the word is defined in the Code at Section 7701(a)(7) to include shares in an association, joint stock company, and insurance company.

The word "securities" is not defined in the Code or Regulations as specifically applied to Section 351 of the new law. In my opinion, it is important to all taxpayers that this word "securities" (as it is intended to apply to Section 351) be carefully defined, taking into consideration the litigation that has been based upon the old law Section 112(b)(5) and with particular reference to the bona fides of the corporate indebtedness, the distinction between notes that are mere promises to pay and the obligations that are in fact considered as actual payment at the time of tender.

The Commissioner's Regulations should remove all doubt and speculation as to the meaning and import of the word "securities" as it is intended to be used and applied with respect to transactions falling within the provisions of Section 351.

Stock as it is used in connection with a Section 351 transaction means the shares of equity capital issued by the corporation and must include voting stock for purposes of control, even though the corporation may have issued other classes of stock.

Generally the word "securities" means obligations issued by a corporation and includes stock of all classes, bonds, debentures, mortgages, certificates of indebtedness, notes, which in the hands of the investor are considered as investments. But, in determining the meaning of the word "securities" for purposes of Section 351, the equity capital shares of the corporation are eliminated. What specific requirements of the Code must be met in qualifying a corporate obligation as a "security" for purposes of Section 351?

Must the corporate obligations, to qualify, be in the form of bonds, debentures, certificates of indebtedness, or other obligations issued in registered form or with the interest coupons attached? Must such obligations be issued in units or denominated amounts? Must the obligations be numbered serially, must the maturity or call dates be not less than a specified time, which may be a relatively short or long period of time, must the obligations bear interest, is any restriction placed on interest rates, and must the obligation of the transferee corporation be secured by property of the corporation? These are questions that should be answered. In a transfer of property from two or more persons, where one incorporator wishes to take all of the stock and another an equal amount in securities, and the property of the corporation could not be mortgaged, would a demand note be considered as meeting the requirements of the definition of "securities" under Section 351?

The answers to these questions are most important to a taxpayer who has or expects to transfer property to a controlled corporation under Section 351. The taxpayer should be able to determine with some degree of accuracy and certainty the potential federal tax liability that may accrue as a result of the transfer of property to a controlled corporation, as it may affect him as the recipient of the stock and securities and as it may affect the corporation which he controls.

The creditor relationship of a stockholder of a controlled corporation has not been changed by the new law. It is important that the taxpayer be informed, of the Court decisions affecting the stockholder-creditor relationship in this type of transaction as they have been reported with respect to Section 112(b)(5) of the 1939 Code.

In *Isidor Dobkin*, 15 TC 31(1950), the transferee corporation issued its interest bearing notes and its capital stock to the transferors in exchange for property. The Commissioner claimed that the notes represented capital contributions. The Tax Court in sustaining the Commissioner and denying the debt status of the notes, said in part:

> "When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution of the corporation's capital and is placed at risk in the business."

In *Ruspyn Corporation*, 18 TC 769(1952) (which related to a disputed deduction for interest on the debentures), the transferers of property received in the exchange pro rata stock and interest-bearing debentures. The Tax Court held that the debtor-creditor relationship did exist and allowed the interest deduction, finding that the securities as issued met the requirements of corporate indebtedness, and said:

> "We feel perfectly sure from the facts which have been stipulated and from the oral testimony that when petitioner was organized and it issued 6,000 shares of common stock with par value of $100 and $2,100,000 face value of debentures in payment of the real estate which it acquired from the then owners, it fully expected to be able to pay the interest on its debentures and to have something substantial left over for distribution to stockholders as dividends on its common stock."

Stock v. debt—tax advantages

There is an obvious tax advantage to the incorporators (transferors) under a Section 351 exchange if they are permitted to allocate a relatively low amount to the equity stock or risk capital and to create a relatively high corporate indebtedness payable to themselves as creditors of the transferee corporation. The advantage lies in (1) the deduction allowable to the corporation as interest paid on the obligations, (2) to the stockholder-creditor with respect to the payments received on the principal of the corporate debt as a return of capital which would be free of tax, and (3) the deduction that would be allowable as a bad debt (if such is a business bad debt) if the corporation should default on its obligation to the creditor. Another advantage (4) lies in the right of the corporation to accumulate earnings and profits for the purpose of liquidating its obligations before imposition of the "accumulated earnings tax" under Section 531. But in order that these enumerated tax benefits may be obtained, the allocation as between corporate risk capital and corporate debt as issued to the transferors must be fair and equitable.

In *Isidor Dobkin, supra*, the ratio of debt to stock was 35 to 1, and in this case the corporate debt included $26,000 of interest bearing notes issued by the corporation to the transferors, plus $44,000 represented by a mortgage on the real estate acquired, a total of $70,000 in contrast to the $2,000 of capital stock issued to the transferors.

In *Ruspyn Corporation, supra*, the Court found that the fair market value of the property acquired was not less than $2,700,000, with capital stock issued in the amount of $600,000 and the 87 year debentures issued in the amount of $2,100,000, resulting in a ratio of debt to stock of $3\frac{1}{2}$ to 1.

In the *Dobkin* case the Commissioner was sustained; and in the *Ruspyn Corporation* case the taxpayer was sustained, the Commissioner acquiescing. No general advice can be given; there is no definitely established ratio of debt to stock upon which the taxpayer may rely in all cases. It appears that the circumstances surrounding each individual case must be carefully analyzed for the purpose of determining whether or not the requirements of the courts may be met.

Control immediately after the exchange

Since the wording of the new law is identical with the 1939 Code, with respect to the term "immediately after the exchange," it is reasonable to assume that the provisions of Regulations 118, 39.112(b)(5)–1, will be effective, which provide: "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Section 368(c) of the 1954 Code says this:

> "Control.—For purposes of part I (other than Section 304), part II, and this part (III) the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power if all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

Stock or securities issued for services

Section 351(a) specifically provides that stock or securities issued for services shall not be considered as issued in return for property. This relates to a situation where a transferor may have received stock and

securities in excess of the value of property transferred, and such excess may be attributed to services rendered either to another transferor or to the new corporation. In another situation stock or securities may be issued to a promoter, who has transferred no property. In either case the value of the services would be taxable to the recipient. If the services were rendered to another transferor, such taxpayer (transferor) would be entitled to a deduction or may realize a taxable gain depending on the circumstances in each case. In the second situation, relating to the promoter, the corporation would be entitled to a deduction to the extent of the value of the stock and securities issued, but the payment may, under certain circumstances, be considered as a payment of organization expenses and be deductible under Section 248 over a minimum period of 60 months. The election to amortize organization expenses applies only to expenditures paid or incurred after August 16, 1954.

Our discussion to this point has been solely confined to a situation where the transferor or transferors of property received nothing but stock or securities in the exchange, and qualified for the full benefits of a non-taxable exchange under Section 351(a). In other situations, where money or other property may be received by the transferor or transferors in the exchange, a taxable gain may arise.

Receipt of other property

Section 351(b) provides for the recognition of gain (if any) if money or other property is received by the transferor or transferors, which gain is limited to the amount of money received or to the fair market value of the property other than money received or to both:

> "(b) Receipt of Property.—If Subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under Subsection (a), other property or money, then—
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
> (A) the amount of money received, plus
> (B) the fair market value of such other property received; and
> (2) no loss to such recipient shall be recognized."

EXAMPLE: A shareholder of a corporation transferred to the corporation equipment with a fair market value of $10,000 for 100 shares of stock and received $2,000 in cash. Immediately after the exchange he owned 800 shares out of a total of 1,000 or 80% of the entire outstanding stock of the corporation. The shareholder would be in control of the corporation and would qualify under Section 351(a) for tax-free treatment. However, if the equipment cost him $8,000 there would be a taxable gain computed as follows:

> Stock has a value of $100 per share or $10,000, plus the cash received of $2,000 or a total value of $12,000, his basis for the equipment was $8,000 a gain of $4,000, but the taxable amount of the gain would be limited to the amount of $2,000, the cash received.

Special rules

The Senate Finance Committee Report at page 265 says: "Under the Internal Revenue Code of 1939, if the transferors in a transaction to which Section 112 (b)(5) was applicable were corporations it was not clear whether a distribution of the stock received by such transferors would prevent the application of such section. Section 351(c) provides specifically, that if a corporate transferor distributes the stock received this will not prevent the application of Section 351. For this purpose it is immaterial whether such a distribution by the transferor is taxable as an ordinary dividend, is taxable at capital gain rates, or is tax free."

> "Section 351(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account."

Since the control is determined by the amount of the stock issued by the transferee corporation and held by the shareholders, whether corporate or not, no reference is made in Subsection (c) to securities. Section 351 (d) provides for other applicable special rules, as cross references under this section.

Assumption of liability

Section 357(a) provides for the assumption of liability by the acquiring or transferee corporation without giving rise to receipt of other property or money by the transferor, as follows:

> "(a) General Rule.—Except as provided in Subsection (b) and (c), if
> (1) the taxpayer receives property which would be permitted to be received under Section 351 . . . without recognition of gain if it were the sole consideration, and
> (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of Section 351 . . . ."

The receipt of money or other property in an exchange is, as a general rule, the basis for gain or loss. In the case of a transfer under Section 351 to a controlled corporation, however, the amount of any indebtedness to which the property transferred is subject, whether the liability is assumed by the transferee

corporation or not, is not considered for this purpose as being other property or money received in the transaction.

In other words, the assets received less the liabilities assumed or taken over by the transferee corporation result in an amount equal to the transferor's net equity in such assets. The "stock and securities" issued by the transferee corporation are issued in an amount equal to the net equity of the transferor or tranferors. This section of the new law is similar to the old law Section 112(k).

Tax avoidance purpose

The old law in Section 112(k) provided for taxing the amount of a liability if it was determined that the transfer of a liability was in fact for the purpose of avoiding the payment of income tax. The new law also makes provision for this purpose, and the Senate Finance Committee Report, with respect to Section 357(b) says: "The language of Subsection (b), relating to assumption of liability for tax avoidance purpose has been changed in one respect from existing law. Where such a tax avoidance purpose exists, the total amount of the liabilities assumed will be considered as money received by the taxpayer and not merely a particular liability with respect to which the tax avoidance purpose existed. This change is intended merely to clarify existing law."

> "Section 357(b)(1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in Subsection (a)—(A) was a purpose to avoid Federal income tax on the exchange, or (B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to the exchange) shall for purposes of Section 351 ..., be considered as money received by the taxpayer on the exchange."

Business purpose

The liability to meet the requirements of the Code must in all events be one resulting from the business transaction and have as a basis for the transfer a bona fide business purpose. For example, in my opinion a bona fide business would be present if the transferors transferred assets of a partnership to the corporation and at the same time transferred all liabilities of the partnership that had accrued to the partnership prior to the exchange. On the other hand, if one of the partners owed a personal debt, which in no way had any connection with the business or the assets of the business, in my opinion, the transfer of such a liability may be considered as one without a bona fide business purpose. And, under these circumstances the transfer of the indebtedness to the corporation would be treated as other property or money and any gain would be taxed to the transferor.

Burden of proof

The burden of proving that the liability transferred was not for the purpose of avoidance of the income tax or that such a transfer has a bona fide business purpose is on the taxpayer. Section 357(b)(2) provides as follows:

> "In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence."

Liabilities in excess of basis

Subsection (c) of Section 357 is new in the 1954 Code and provides for the recognition of gain in the event the transferred liabilities exceed the basis of the transferred assets.

> "Section 357(c)(1) In general. In the case of an exchange—(A) to which Section 351 applies . . . if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

Exceptions

If for any reason which relates to a purpose to avoid the income tax or, if not for that purpose, the liabilty transferred was not for a bona fide business purpose, and the gain on the transfer of a liability is taxed under Section 357(b)(1) then paragraph (1) of Section 357(c) would not apply.

The Senate Committee Report says "Thus if an individual transfers, under Section 351, property having a basis in his hands of $20,000, but subject to a mortgage of $50,000, to a corporation controlled by him, such individual will be subject to tax with respect to $30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor."

The Senate Committee Report says: "The determination of whether a gain resulting from the transfer of capital assets is long- or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred."

Basis of property exchanged

There are two separate bases to be determined with

respect to the property in the exchange: (1) the basis of the property received by the transferors, and (2) the basis of the property received by the transferee. Section 358 of the new law restates in general the substance of Section 113(a)(6) of the 1939 Code with respect to transferors receiving stock or securities and in some cases other property. Section 362 of the new law corresponds generally to Section 113(a)(7) and (8) of the 1939 Code, with respect to the basis of property received by the acquiring corporation in an exchange under Section 351.

Basis to distributees

The property distributed to the distributees has reference to the shares of stock or the securities issued by the acquiring corporation, or to other property transferred by the acquiring corporation to the transferors as they are defined for the purpose of Section 351.

"Section 358(a)(1) Nonrecognition property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by— (i) the fair market value of any other property (except money) received by the taxpayer, and (ii) the amount of any money received by the taxpayer, and

(B) increased by (i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

"Section 358(2) Other property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value."

If the basis of the property transferred to the corporation was $10,000 in the hands of the transferors, and the transferors received stock or (and) securities in the exchange, then the basis of the stock or (and) securities will be $10,000 ratably apportioned over the total number of shares or securities. If only common stock is received by the transferors in exchange for the property the basis per share is determined by the simple process of dividing the total number of shares into the total determined basis.

If the transfer of assets is made to a newly organized corporation under the provisions of Section 351, then normally only stock or securities would be transferred to the distributees (transferors of property). This is true because the corporation would not have previously acquired property or accumulated earnings.

Treated as a dividend

The reference to the increase in basis attributable to a dividend under Section 358(a)(1)(B)(i) is explained in the Senate Committee Report as follows: Under these circumstances, the provisions of Section 358(a)(1) would apply only with respect to the first part of the section and without regard to decreases under paragraph (A) or to increases under paragraph (B) and the related subparagraphs (i) and (ii).

If the transfer of assets is made to a corporation which has previously acquired property and accumulated earnings to the date of the transfer, then paragraphs (A) and (B) would apply, with respect to the decreases and increases as the case may be.

EXAMPLE 1: The transferors in a Section 351 exchange had an established basis of $100,000 for the property transferred to the acquiring corporation. The corporation in exchange for such property issued its common stock in the total amount of $100,000. In this case the basis of the stock in the hands of the transferors would be $100,000.

EXAMPLE 2: The transferors in a Section 351 exchange had an established basis of $100,000 for the property transferred to the acquiring corporation. The corporation in exchange for the property issued its common stock in the total amount of $90,000 to the transferors, and in addition transferred property with a fair market value of $5,000 and paid to the transferors $5,000 in cash. The basis of the stock received would be $90,000, determined as follows. The basis of the property permitted to be received is $100,000 reduced by the fair market value of other property received, $5,000, and by the amount of $5,000 received in cash. Since the basis was $100,000 and no gain was realized on the exchange, the provisions of Section 358(a)(1)(B) would not operate to increase the basis. In this, and in Example 1, the fair market value is $100,000.

EXAMPLE 3: The transferors in a Section 351 exchange had an established basis of $100,000 for the property transferred to the acquiring corporation, but the property transferred had a fair market value of $120,000. The corporation issued its common stock to the transferors in the total amount of $100,000 and, in addition, transferred to the taxpayers (transferors) other property valued at $5,000 and paid to the taxpayers (transferors) the sum of $5,000 in cash. The basis of the stock in the hands of the transferors would be determined as follows:

(1) Property permitted to be received under Section 351 without the recognition of gain or loss -(a)(1)-		$100,000
(A) Decreased by the fair market value of other property received in the exchange (i)	$ 5,000	
Decreased by the cash received (ii)	5,000	10,000
Adjusted balance		90,000
(B) Increased by the amount of gain recognized on the exchange-limited to cash received (ii)		5,000
Basis of the stock in hands of the transferors		$ 95,000

"The increase required by the amount of any recognized gain does not for the purpose of paragraph (1) include any portion of any gain which was treated as a dividend. The reference in paragraph (1) to an amount which was 'treated as a dividend' does not appear in Section 113(a)(6) of the 1939 Code and is included primarily to take into account the fact that 'other property' received in an exchange for Section 306 stock under part III is specially taxed."

Senate comment on Section 306 stock

With respect to Section 306 stock, the Senate Committee Report says: "In general, Section 306 stock is preferred stock issued as a stock dividend, whether in connection with a corporate reorganization or otherwise, at a time when the issuing corporation has earnings and profits. The rules are described in Section 306(a)–(h) inclusive."

Allocation of basis

Section 358(b)(1), the general rule, would apply to Section 351 exchanges with respect to the allocation of basis to the properties permitted to be received without the recognition of gain or loss. Paragraph (2) of Section 358(b) and Subsections (c) and (d) of Section 358 do not apply to Section 351 exchanges.

> "Section 358(b)(1) In general.—Under regulations prescribed by the Secretary or his delegate, the basis determined under Subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss."

The Senate Committee Report says, "Section 358(b) provides that where several kinds of stock or securities are received, the Secretary may prescribe rules for the allocation of the basis among them. This provision for allocation is also made applicable to cases in which only part of the stock owned is exchanged."

All of the comments and references with respect to basis and allocation of basis in the preceding paragraphs are made in connection with the basis of the transferee, and Section 358(e) provides as follows: "This section shall not apply to property acquired by a corporation by the issuance of its stock or securities as consideration in whole or in part for the transfer of property to it."

Basis to corporations

Section 362(a) relates to the basis of corporations acquiring property in an exchange under Section 351. And provides,

> "(1) If property was acquired on or after June 22, 1954, by a corporation—in connection with a transaction to which Section 351 (relating to transfer of property to a corporation controlled by transferor) applies, or
> (2) as paid in surplus or as a contribution to capital,
> then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer."

Subsection 362(a) corresponds generally to Section 113(a)(8) of the 1939 Code and provides rules respecting the basis of property acquired on or after June 22, 1954, by a corporation in connection with a corporate organization, as paid in surplus, or as a contribution to capital as a result if a Section 351 exchange. (Senate Committee Report, page 271.)

Since no substantive change has been made in the law with respect to basis in the hands of the acquiring corporation, it is reasonable to assume that Regulations 118, 39.113(a)(8)–1 will be effective, except with respect to the date changes made in the 1954 Internal Revenue Code.

Special rule

Section 362(c) is new in the 1954 Code which relates to contributions to capital of a corporation in certain cases by persons other than shareholders. The Senate Committee Report says: "Subsection (c) has no counterpart under existing law (old 1939 Code). This Subsection provides rules respecting situations similar to that which occurred in *Brown Shoe Co.* v. *Commissioner* (339 U.S. 583). Paragraph (1) in Subsection (c) provides, that in such a case, if property, other than money, is acquired by a corporation after June 18, 1954 [*sic*, the law says June 22, 1954], as a contribution to capital and is not contributed by a shareholder as such, then the basis of such property to the corporation shall be zero.

"Paragraph (2) of Subsection (c) provides that if money is received by a corporation, after June 18, 1954 [*sic*] as a contribution to capital and such money is not contributed by a shareholder as such, then the

Cross References in New Code

Section 351(d) of the 1954 Code gives us these cross references for purposes of that section:

"1. For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see Section 357.

"2. For the basis of stock, securities, or property received in an exchange to which this section applies, see Sections 358 and 362.

"3. For special rule in the case of an exchange described in this section but which results in a gift, see Section 2501 and following.

"4. For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see Section 61(a)(1)."

basis of any property acquired with such money during the 12 months' period beginning with the day the contribution is received shall be reduced by the amount of the contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied in reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the corporation. The particular properties to the bases of which the reduction shall be allocated shall be determined under regulations prescribed by the Secretary."

Effective date—elections

The effective date of the provisions of part III of subchapter C are contained in Section 393 of the new law, which provides as follows:

"(a) General Rule.—Except as otherwise provided in this subchapter, part III . . . shall take effect on June 22, 1954.

"(b) Special Rules for Plans of Reorganization.—
(1) In general.—Except as provided in paragraphs (2) and (3), part III . . . shall apply only in respect of plans of reorganization adopted after June 22, 1954. For purposes of this paragraph and paragraphs (2) and (3), a plan to make a transfer to a controlled corporation described in Section 351 . . . shall be treated as a plan of reorganization.
(2) Election to have 1939 code apply—if—
(A) a plan of reorganization was submitted to the Secretary or his delegate before June 22, 1954, but such plan was not adopted before such date,
(B) the Secretary or his delegate issues (whether before, on, or after such date) a ruling with respect to such plan, and
(C) the corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this paragraph apply,
then, if such reorganization is completed in accordance with the plan so submitted, the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to their shareholders and security holders) shall be determined under the Internal Revenue Code of 1939 (in accordance with the contents of such ruling) and not under this Code.
(3) Election to have 1954 Code apply—if—
(A) a plan of reorganization—
(i) was adopted after March 1, 1954, and before June 22, 1954, or (ii) was adopted before June 22, 1954, in pursuance of a court order and all distributions under the plan occur after March 1, 1954, and before July 1, 1954, and
(B) the corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribed) to have this paragraph apply,
then the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to their shareholders and security holders) shall be determined under this Code and not under the Internal Revenue Code of 1939."

Conclusion

With reference to the term "stock or securities" and the allocation of the total amount received as stock and securities by the transferors in a Section 351 exchange special consideration should be given to the need for risk capital in the corporation. It is true that the earnings and profits accumulated by the proprietor or by the partnership prior to such an exchange have been taxed, and it is reasonable to assume that the incorporators are aware of this fact, and are in every case desirous of minimizing the tax bite. The fact remains that a thin incorporation may result in serious tax consequences. Plan carefully before a transfer is made; the proprietor or the partners may have an excess of cash on hand which could be withdrawn from the business prior to a Section 351 transfer. Examine carefully the book and fair market value of the assets to be transferred, and be sure that such liabilities as are transferred to the corporation represent bona fide business obligations. The Commissioner's Regulations, with respect to the old 1939 Code and Section 112(b)(5), are effective to the extent that such regulations are not inconsistent with the new law. Under the old law the regulations required the keeping of certain records and the filing of certain information in connection with a Section 112(b)(5) exchange. In my opinion the requirements of Regulations 118, 39.112(b)(5)–3 are still effective with respect to the keeping of records and the filing of information as such regulations are applicable to a "Transfer to a Corporation Controlled by Transferors" under Section 351 of the 1954 Code. ☆

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Beware these two "loopholes" to get preferred-stock bailout under 1954 Code

by MILTON A. DAUBER

The new tax law was supposed to close the preferred-stock bailout which had a temporary respectability after the Chamberlin decision. Now we hear tax men discussing two tricky propositions to get a bailout under the 1954 Code. This author, while he says beware, describes how the new supposed "loopholes" work. Make your own decision as to whether they're any good

THE PREFERRED STOCK BAILOUT, a device of great potency for the conversion of dividend income into capital gain, was sanctioned by the decision of the Sixth Circuit, reversing the Tax Court, in *Chamberlin* v. *Commissioner* (207 F. (2d) 462 (6th Cir. 1953), cert. denied 347 U.S. 918 (1954)). Congress, in Section 306 of the new Code, has attempted to block this means of avoidance. The bare statutory language of that section appears to leave open two possible means to achieve a bailout; but since both are subject to serious attack under the business purpose doctrine, the author advises extreme caution in recommending them to clients. The purpose of the analysis which follows is to report and evaluate these two techniques which are being discussed currently by tax men, to set them in their factual context, and to advise caution in their use.

How the bailout works

The bailout device was essentially simple under the 1939 Code. The *Chamberlin* case, above, and the findings of the Tax Court in that case, illustrates a typical bailout (18 TC 164 (1952)). Let us assume that a corporation with only common stock outstanding had $1,000,000 in earnings and profits, represented entirely by liquid assets, which the principal or sole shareholder desired to draw off in a single year. The issuance of a cash dividend in this amount was obviously out of the question. The shareholder would go to an insurance company, or other monied corporation, and arrange informally for the purchase by it of preferred stock in his company. The terms of the preferred would be dictated by the purchaser, but the shareholder would insist that the stock be redeemable within a relatively short period—say, ten years. This feature would prevent any permanent dilution of the shareholder's proprietary interest in his corporation. After reaching an informal agreement, the shareholder would cause the issuance by his company of a dividend in preferred stock having the agreed-upon characteristics. Under the decision of the Supreme Court in *Strassburger* v. *Commissioner* (318 U.S. 604 (1943)), the issuance of such a dividend, at a time when only common stock was outstanding, was tax free. The stock was, of course, a capital asset; and, being a tax-free distribution, the shareholder was able to tack its holding period with the holding period of the common stock with respect to which the preferred had been issued ((1939) Sec. 117(h)(5). This rule is carried forward in Sec. 1223(5) of the new Code). Hence, he could sell the preferred to the insurance company immediately after issuance, and the gain would be taxable as a long-term capital gain (assuming, of course, that the common stock had been held by him for more than six months). Since the preferred stock would have had a portion of the basis of the

common allocated to it,[1] the amount of the gain would have been less than the entire proceeds of the sale, and the tax cost of the bailout would have been less than 25% (or 26%, in recent years) of the dividend. The stock would be redeemed out of the accumulated earnings and profits and, after redemption, the shareholder would once again have been in sole control.

How Congress attacks the bailout

Congress, in the new Code, attacked this device in essentially the same manner as it had previously attacked the "collapsible" corporation (see (1939) Sec. 117(m)(1); (1954) Sec. 341(a))—by taking the transaction out of the capital gains class. Section 306 of the new Code creates a new concept—"Section 306 Stock"—and imposes upon the sale of such stock the tax consequences, in general, of a sale of a non-capital asset. As we shall see, however, the sale of a non-capital asset is a tax bargain when compared with the sale of Section 306 stock.

The best approach to the understanding of Section 306 would appear to be through the definitions (Sec. 306(c)). There are three sets of circumstances under which stock will be classed as Section 306 stock. They are:

(A) Stock (other than common issued with respect to common) in the hands of the original distributee, which was distributed in a transaction wholly or partly tax free under Section 305(a) (Sec. 306(c)(1)-(A)). This, in effect, means all distributions of stock dividends, except for dividends of common on common.

(B) Stock (other than common), in the hands of the original distributee, which was received in a reorganization, spinoff, splitoff, or splitup, which was tax free in whole or in part, but only to the extent that (i) the stock so distributed was substantially equivalent to a stock dividend, or (ii) the stock was distributed in exchange for other Section 306 stock (Sec. 306(c)(1)(B)). For example, if a corporation creates a subsidiary and transfers a part of the business to it, receiving in exchange common and preferred stock of the subsidiary which it in turn distributes to its own shareholders, the transaction is a tax-free spinoff under Section 355. Assuming that the distribution amounted to a preferred stock dividend, as it arguably did, the preferred of the subsidiary is Section 306 Stock in the hands of the shareholders of the parent.

(C) Stock, in the hands of any person, the basis of which is determined in whole or in part by reference to the basis, in the hands of any person, of Section 306 Stock (Sec. 306(c)(1)(C)). For example, if one receives a preferred stock dividend, such dividend will be Section 306 stock in his hands by virtue of definition (A). If he thereafter gives such preferred stock in exchange for the issuance of common stock by a corporation controlled by him (which would be a tax-free contribution under Sec. 351(a)), the basis of the preferred in the hands of the corporation would be the same as its basis had been in the hands of the shareholder (Sec. 362(a)), while the basis to the shareholder of the newly issued common would be the same as the basis of the preferred had been in his hands (Sec. 358(a)(1)). Consequently, the preferred is Section 306 stock in the hands of the corporation, and the new common is Section 306 stock in the hands of the shareholder.

For the purpose of applying the above definitions, stock rights are to be treated as stock (Sec. 306(d)), and convertible common stock is to be treated as the stock or other property into which it can be converted (Sec. 306(e)(2)).

Two exceptions to these rules

There are two exceptions to the operation of these definitions. The first is that, if the distribution of stock under definition (A) or (B) would not have constituted a dividend had cash been distributed in lieu of stock, then the stock shall not be considered as Section 306 stock (Sec. 306(c)(2)). It should be noted that this exception applies only if no part of a cash distribution would have been a dividend; consequently, only a corporation which has no earnings or profits during any part of the year of distribution, and no accumulated earnings and profits, can take advantage of the exception (Sec. 316(a)).

The second is that, if Section 306 stock was issued with respect to common stock, and the Section 306 stock is thereafter converted into or exchanged for common stock of the same corporation, the common stock so received shall not be considered Section 306 stock (Sec. 306(e)(1)).

Tax treatment of 306 stock

We turn next to the operative provisions of Section 306. They prescribe differing tax treatment for redemptions of Section 306 stock and for dispositions other than redemptions.

In the case of a disposition other than a redemption, the *entire proceeds* received for the Section 306 stock is to be treated as gain from the sale of a non-capital asset, but only to the extent that a distribution of cash, instead of stock, would have constituted a dividend (Sec. 306(a)(1)(A)). The amount so taxed, if less than the entire proceeds, is added to the adjusted basis; and, if the balance of the proceeds exceeds such sum plus the adjusted basis, the difference is to be treated as gain from the sale of the stock (Sec. 306(a)-(1)(B)). Typically, that will mean long-term capital gain. In the case of a sale of a part of the stock, where the proceeds exceed the "dividend amount," but fall short of the "dividend amount" plus the adjusted basis

[1] (1939) §113(a)(19)(A); Regs. 118, §§39, 113(a)(19)-1 and 113(a)(12)-1. Section 307(a) of the new Code re-enacts this rule.

of the stock sold, it does not appear that any favorable adjustment to the basis of the remaining stock can be made. No losses are to be recognized upon a sale of Section 306 stock (Sec. 306(a)(1)(C)).

In the case of a redemption, the proceeds are to be treated as a distribution under Section 301 (Sec. 306(a)(2)). Thus, the proceeds will be treated as a dividend to the extent of earnings and profits at the time of redemption (Sec. 301(c)(1); 316(a)), any excess being applied first in reduction of adjusted basis and thereafter treated as gain from the sale of the stock (Sec. 301(c)(2), (3)(A)).

Five exceptions to rule of Section 306

There are five exceptions to the operation of Section 306. A sale or other disposal is not within the Section if it (i) is not to a person whose ownership of the stock would be attributable to the selling shareholder under the constructive stock ownership rules of Section 318, and (ii) if it results in termination of the selling shareholder's proprietary interest in the Company (Sec. 306(b)(1)(A)). In determining this, however, the constructive stock ownership rules of Section 318, attributing to a person the stock owned by certain relatives, corporations, etc., will be applied.

A redemption to which Section 302(b)(3) applies is also excepted (Sec. 306(b)(2)). This is, ordinarily, a redemption in total termination of the shareholder's interest, and the constructive ownership rules apply. However, Section 302(c)(2) exempts a redemption in termination, under Section 302(b)(3), from the constructive ownership rules under certain circumstances, and that exemption would presumably apply as well to redemptions of Section 306 stock.

A true partial or complete liquidation will also be excepted from Section 306 (Sec. 306(b)(2)). In this connection, it should be noted that the new Code incorporates the "business contraction" test for partial liquidations (Sec. 346(b)).

A most important exception is that Section 306 will not apply to any disposition of Section 306 stock which, under any provision of Subtitle A (Income Taxes), does not result in recognition of gain or loss to the disposing shareholder (Sec. 306(b)(3)). However, since most, if not all, tax-free dispositions result in a carryover or substituted basis (see Secs. 358, 362, 1015) the usefulness of this exception is qualified by definition (C), (Sec. 306(c)(1)(C)), which stigmatizes as Section 306 stock any stock having a basis determined with reference to the basis of Section 306 stock.

A fifth exception is the case in which it can be established to the Commissioner's satisfaction that tax avoidance was not a principal motive for the distribution and disposition of the stock (Sec. 306(b)(4)). It is expected that the primary use of this exception will be in connection with distributions by publicly held corporations, or in connection with reorganizations which, while they might have the effect of a stock dividend, nonetheless have a primarily business motivation.

Section 306 also provides that, if the terms and conditions of any stock are changed, then the fair market value of such stock, and its ratable share of earnings and profits, shall be determined as of the date of distribution or the date of change whichever is disadvantageous to the shareholder (Sec. 306(g)(1), (2)). Similarly, if it is claimed that the stock is not Section 306 stock because of the absence of earnings and profits, such must be the fact at both the time of distribution and the time of change (Sec. 306(g)(3)).

Finally, Section 306 carries its own qualified effective date rule, and applies only with respect to stock issued after June 22, 1954 (Secs. 306(h), 393(a)).

The Senate Finance Committee Report and the Conference Committee Report discuss Section 306 in great detail. Inasmuch as reprints of these Reports have been made widely available by the publishers of the major tax services,[2] there is no need to summarize the legislative history here, nor to draw the plain implications of the statutory language. We may turn immediately to the question of how the advantages of the old-style bailout may be obtained under the new statutory scheme.

How Partnership Bailout Plan Works

In a situation where there is more than one shareholder, and where their common stock in the corporation has a high basis relative to fair market value, the bailout might be accomplished through the medium of a "collapsible" partnership. Let us assume that A, B, and C (who may be related or not) acquired all of the stock of a corporation in 1946, at a price of $3,000,000, and that the fair market value of that stock in November, 1954, is $5,000,000. This increase in value is attributable to earnings and profits accumulated over the past eight years, and consists mostly of liquid assets. The shareholders desire to draw off the $2,000,000. They consult an outside group of investors, who may be either individuals or corporations, and ascertain the conditions upon which they will invest in preferred stock of the corporation. Thereafter, a dividend of redeemable preferred stock, meeting the requisite conditions, will be issued by the

corporation. This stock, of course, will be Section 306 stock in the hands of A, B, and C.

Concurrently, A, B, and C will form a partnership for investment purposes, contributing thereto money or securities, which partnership will be placed upon a calendar year basis (as A, B, and C assumedly are). This would be required, in any event, for any partnership taxable year adopted after April 1, 1954 (Secs. 706(b), 771(b)(1)(A)). After January 1, 1955, A, B, and C will contribute their Section 306 stock to the partnership.[3] Under Section 721, no gain or loss is recognized upon contribution of property to a partnership; consequently, the exception contained in Section 306(b)(3) will apply, and this transfer will be free of Section 306 tax.

Under Section 307(a), and under Regulations implementing similar provisions of the 1939 Code (see footnote 1), the preferred stock dividend, when issued, will acquire, as its basis, an allocated portion of the basis of the common stock. Since the preferred stock will amount to 40% in value of the total fair market value of the preferred and common together (the preferred having an assumed value of $2,000,000, thus reducing the value of the common to $3,000,000), the preferred will receive a basis equal to 40% of the basis of the common. Since the basis of the common is $3,000,000, the basis of the preferred, in the hands of the several shareholders, will aggregate $1,200,000. Thus, upon contribution, the basis of the several partnership interests will, in the aggregate, be increased by $1,200,000.

Sale to investors as in Chamberlin

The next step will be for A, B, and C to sell their partnership interests to the selected outside investors. Under prior law, of course, this would have constituted a capital transaction, but this is not true under the new Code. The new Code provides that gain on the sale of a partnership interest, to the extent that it is attributable to "appreciated inventory items," shall be treated as gain from the sale of a non-capital asset (Secs. 741, 751(a)). The definition of "appreciated inventory items" includes, not only stock in trade and the like, but also all property which is a non-capital asset in the hands of the partnership, or which would be such in the hands of the partner in question (Sec. 751(d)(2)(B),(C)). The preferred stock, of course, fits this definition upon both counts,[4] and therefore the sale of the partnership interests will result in ordinary income to the partners, in the aggregate, to the extent that the fair market value of the preferred stock exceeds the partnership basis attributable to that stock. Under the figures which we have assumed, the amount of that gain will be $800,000. If we assume further that all three of the partners (A, B, and C) are in the highest income tax bracket, the aggregate tax cost of the bailout will be $728,000 (subject to possible adjustment by reason of the over-all 87% tax limitation) (Sec. 1(c)), or 36.4% of the entire dividend which has been bailed out. This is less advantageous than the $200,000 which would have been the tax cost of the bailout under prior law; but it is distinctly more advantageous than the payment of maximum bracket taxes upon the entire $2,000,000.

Some note should be taken of the "loophole" which makes the partnership bailout possible. You will recall that the direct sale of Section 306 stock would result in the taxation of the entire proceeds as ordinary income. On the sale of a partnership interest with value attributable to "inventory items" however, only the appreciation in value over adjusted basis is treated as ordinary income.[5] Since Section 306(c)(1)(C) includes, as Section 306 Stock, only *stock* having a substituted basis, but not other forms of property, the shareholders are free to employ the partnership as a means of utilizing the allocated basis of the Section 306 shares, thereby vastly reducing the effective tax cost on the bailout.

Tax treatment of purchaser of stock

We must, of course, consider this transaction from the standpoint of the purchaser, in order to assay its practicability. It is evident that the preferred stock is Section 306 stock in the hands of the partnership, and that it would remain such in the hands of the transferee partners if distributed to them. This will result from Sec. 306(c)(1)(C), made applicable due to the carryover basis provisions of Secs. 723 and 732(a), (b), (c)(1). What means are available to prevent them from incurring any tax cost upon disposition of the stock? Sections 754 and 743 of the Code permit the partnership to make an election with respect to basis for the benefit of transferee partners. Under this election, the adjusted basis, in the hands of the

[2] *E.g.*, CCH STAND. FED. TAX REP., Special Releases; "Official Explanation of the Int. Rev. Code of 1954" (ed. by Prentice-Hall); RABKIN & JOHNSON, FED. INC., GIFT & EST. TAXATION, Code Vol.

[3] The delay until 1955 is in order that the transaction may be governed entirely by the new Partnership sub-chapter, which applies in general only to taxable years beginning after December 31, 1954. §771(a)(1)(A).

[4] Since the basis of the preferred stock in the partnership hands is the same as its basis in the hands of the contributing partner (§723), §306(c)(1)(C) will apply, and the stock will be a non-capital asset to the partnership. And, of course, the stock would, in the hands of the partner, be within the scope of §306(c)(1)(A).

[5] §741; Sen. Fin. Comm. Rep., No. 1622, p. 401 ff. (83d Cong., 2d Sess., 1954).

[6] Some question may arise at this point as to whether a corporation may be a partner, under applicable state law. The authorities, pro and con, are fully discussed in 6 *Fletcher, Cyc. Corp.* §2520 (Perm. Ed. 1950). It is there pointed out that any rule against partnership would not prevent a corporation from entering a joint adventure. Such an enterprise is taxable as a partnership, §§761(a), 7701(a)(2), and it may be that the "bailout" association may be cast as a joint venture.

[7] *E.g., R. O. H. Hill, Inc.*, 9 T.C. 153 (1947); *Cf. Byers* v. *Comm'r.*, 199 F. 2d 273 (8th Cir. 1952).

partnership, of each class of partnership assets will be further adjusted by the amount in which the transferee's cost of acquiring his partnership interest, with respect to such class of assets, exceeds said adjusted basis. After having made this elective adjustment, the partnership will continue to hold the preferred stock until the time for redemption of the issue as a whole arrives. If required by the purchasers, the stock may carry provisions for a redemption sinking fund to secure ultimate redemption. Upon redemption, the tax consequences will be tested, under general partnership tax rules, as though it were a redemption by the partners themselves (Secs. 701, 792(a)(8), (b)). Since each partner will be disposing of his entire interest in the corporation, Section 306 will not apply, and the redemption will be treated, under Section 302-(b)(3), as a sale or exchange of the stock (Sec. 306(b)(1)(B)). Since the basis of the stock, as to each transferee, has already been adjusted up to fair market value, there will be no tax effect upon the redemption by the purchasers of the bailout stock.

The foregoing program will be applicable to both corporate and individual partners.[6] If a corporate partner is involved, however, annual redemptions may be permitted. In such case the redemption proceeds, other than the final installment, will be taken into the gross income of the corporation as dividends, and will be taxed at an effective rate of approximately 7.5%, due to the intercorporate dividend credit (Secs. 243(a), 246). However, if such a course is pursued, the sale price and stated dividend rate of the preferred shares must be adjusted so as to yield to maturity the desired rate of return. The necessary computations can be easily made through the use of standard tables showing the yield to maturity of bonds purchased at a premium.

Hazards facing this method

The foregoing program is, obviously, available only in cases where there is more than one shareholder, and where the basis of the common stock is sufficiently high, and the ratio of market values between the dividend preferred and the common sufficiently close, to reduce the practical impact of taxation at top-bracket rates. There is, moreover, a much more fundamental limitation on the feasibility of such a bailout. A serious question will arise, in every case, of whether the "business purpose" doctrine might be applied so as to dissolve the elaborate technical structure and treat the sale of the partnership interest as a sale of the Section 306 stock itself.

A partnership is defined in the Code as an organization for the carrying on of a business, a financial operation, or a venture (Sections 761(a), 7701(a)(2)). While the Code itself recognizes that a partnership may properly exist for the carrying on of purely investment functions (see Sec. 761(a), giving such partnerships an election to disregard the partnership entity), nonetheless the statutory definition clearly implies the necessity for a "business purpose." Where, as here, the tax consequences of a transaction depend upon the recognition of the partnership entity as such, the absence of a *bona fide* business purpose may lead to the disregard of that entity.[7] No set formula can be prescribed for protection against this very real hazard; the tax adviser must scrutinize the entire situation in each particular case and use his own judgment as to whether, on balance, the operating incidents of the proposed "collapsible" partnership are sufficient to evidence a business purpose apart from the avoidance of Section 306. Obviously, wherever possible, the utilization of a partnership which predates the origination of the bailout plan is highly to be desired.

A second hazard arises out of Section 708 of the Code. It is there provided that a partnership shall terminate upon the sale of 50% or more of the ownership interest within a twelve month period (Sec. 708-(b)(1)(B)). That section is, quite obviously, intended to apply primarily in deciding the question of when a partnership taxable year terminates, as related to the further question of the taxable year of the partners in which income must be taken up. Nonetheless, the section is expressly applicable to the entire subchapter, and might provide the basis for some argument by the Commissioner to the effect that the sale of all of the partnership interests works a termination and distribution, whereby the partners will be deemed to have received the Section 306 Stock as a liquidating distribution, and then to have sold such stock itself. The legislative history casts no light upon the scope of Section 708; and, while the argument above suggested may be far-fetched, its ultimate acceptance by the courts would not be the strangest event in income tax history.

How the Corporation Bailout Plan Works

There appears to be a second possible method for achieving a bailout under the new Code, and this method depends neither upon the number of shareholders nor upon the adjusted basis of the outstanding stock of the corporation involved. Let us suppose that A is the sole shareholder in corporation C, which is engaged in trade or business and has only common stock outstanding. A's shares have a fair market value of $5,000,000, and the corporation has earnings and profits of $2,000,000, mostly in liquid form. As stated

above, A's basis for the C shares is unimportant. The first step in the bailout will be the formation of a holding company, HC, to which A will transfer all of the C stock in exchange for all of the HC stock. This will be a tax-free transaction under Sec. 351. C will now declare a dividend of preferred on common to HC. This preferred will, of course, be Section 306 stock in the hands of HC. However, it will not represent taxable income to HC upon receipt (Sec. 305(a)) nor will it increase the earnings and profits of HC. Under Section 307(a), the basis of the C stock must be apportioned between the old common and the new preferred; and in such cases the tax-free distribution has no effect upon the earnings and profits of the recipient corporation (Sec. 312(f)(2)(B)).

The next step will be for HC to distribute the C preferred to A. While this distribution is undoubtedly a "disposition" of Section 306 Stock by HC, it will not be subject to taxation under 306. The general rule laid down in § 311(a)(2) is that no gain or loss is recognized to a corporation upon a distribution of property. There are two exceptions to this rule, but neither applies here.[8] Hence, the distribution of the C preferred by HC is tax free under the non-recognition exception of Section 306 (Sec. 306(b)(3)).

Nor would this distribution be taxable to A as a dividend. It would not have been so taxable even under prior law. In *Commissioner* v. *Fannie Hirshon Trust* (213 F. 2d 523, 2d Cir. 1954 certiorari denied), and *Commissioner* v. *Estate of Ida S. Godley* (213 F. 2d 529, 3d Cir. 1954), the Third Circuit held that, where the earnings and profits of a corporation are at least equal to the adjusted basis of property distributed as a dividend, then the entire fair market value of such property is taxable as a dividend to the recipient, even though such fair market value exceeds earnings and profits. There is some difference of opinion as to whether or not the doctrine of these cases is repudiated by the new Code. Since, in our example, HC has no earnings and profits those decisions would have been inapplicable. And there is no provision of the new Code which would result in dividend taxation of the C preferred in A's hands. There are certain new provisions which increase the earnings and profits of the corporation to some extent, and consequently result in dividend taxation to the shareholder, upon the distribution of property. The only such provision we need consider is Section 312(b), imposing this treatment upon the distribution of appreciated inventory. The definition of "inventory items" in Section 312(b)(2)(A)(i), (ii) is narrower than its counterpart in the Partnership subchapter (Sec. 751(d)(2)). As defined in Section 312, the term includes only true inventory items and goods held for sale to customers, but does not include any and all property which, in the hands of the corporation, is a non-capital asset. Hence, a distribution of Section 306 Stock does not incur the penalty imposed upon a distribution of inventory.

Nor would the distribution be a personal holding company distribution taxable as a dividend under Section 316(b)(2). Such a distribution is taxable as a dividend only to the extent of the undistributed personal holding company income. That phrase is defined in Section 545 as the taxable income, with certain adjustments. "Taxable income" is defined in Section 63(a) as gross income minus deductions; and, since Section 305(a) excludes stock dividends from gross income, HC would have no gross income, no taxable income, and no undistributed personal holding company income.

Finally, the distribution of the C preferred by HC would not be taxable as a "collapsible corporation" distribution. Once again, it is a question of definitions. The "collapsible corporations" provisions apply only to corporations holding "Section 341 assets" (Sec. 341(b)(1),(2)), and the definition of that term is not broad enough to include Section 306 Stock (Sec. 341(b)(3)).

Nature of the C stock distribution

What character, then, will the distribution of the C preferred to A have? At the outset, it can be seen that it will not be a tax-free distribution. The only possible way of subjecting the distribution to non-recognition would be through the operation of Section 355. However, since HC would not divest itself of control of C by the distribution, the "spin-off" provisions of 355 will not apply (Sec. 355(a)(1)(D), and gain must be recognized. The effect of the distribution will then be governed by Section 301. Under that Section, A will take the stock into account at full market value (Sec. 301(b)(1)(A)), applying it first in reduction of basis and treating the excess, if any, as gain upon the sale of his HC stock (Sec. 301(c)(2)(3)(A)). We have assumed that the fair market value of the preferred is $2,000,000. Hence, if A's basis for the HC stock, which is the same as his former basis for the C stock (Sec. 358(a)(1)), is $2,000,000 or better, he will incur no tax. In the event that the basis is less than $2,000,000, he will pay a capital gains tax. And, since the tax-free exchange with HC resulted in a tacking of his holding periods for the C stock and the HC stock,[9] the gain will ordinarily be long-term. The basis of the C preferred

[8] Gain will be recognized to the corporation upon distribution of LIFO inventory, §311(b), and of property subject to a liability in excess of its adjusted basis, §311(c).

[9] §1223(1). It should be noted that the tacking of holding periods is allowed under the new Code only if the property surrendered on the exchange is a capital asset.

[10] It must be remembered that the distribution of the C preferred, in our example, has materially reduced the basis of the HC stock, possibly to 0. Since the C stock was acquired by HC after December 31, 1953, the elective tax-free liquidation provisions of 0333 cannot be utilized.

[11] *Preferred Stock Dividends: Permanency of Interest and the Federal Income Tax Law*, 8 RUTGERS L. REV. 472 (Summer, 1954).

[12] If feasible from the standpoint of marketability, these objections can be met in part by using preferred stock which is callable, but not subject to mandatory redemption.

stock in A's hands, of course, will be its fair market value (Sec. 301(d)(1)).

And this is the key to the bailout. You will recall that, under Section 306 (c)(1)(A) and (B), the tax penalty of Section 306 applies to Section 306 stock only when sold by the original recipient; and that the stock retains its character as Section 306 Stock in the hands of a transferee only when the transferee's basis is determined by reference to the basis of the stock in the hands of the original recipient (Sec. 306(c)(1)(C). Hence, the C preferred is not Section 306 Stock in A's hands. He is now free to consummate its sale. Since the stock will presumably be sold at not more than its market value, A may sell it immediately, even though his holding period is less than six months, since there will be gain realized upon the sale.

Hazards facing corporaton bailout plan

While this form of bailout appears technically sound, when considered solely within the four corners of the Code, it (like the partnership bailout) is beset with the very great danger of the Commissioner's refusal to recognize the corporate entity of HC. In that event A would be treated as the original distributee of the preferred shares, and his sale of those shares would fall squarely within the Section 306 trap.

The reader need hardly be reminded of such decisions as *Higgins* v. *Smith* (308 U.S. 473 (1940)), and *National Investors Corp.* v. *Hoey* (144 F. 2d 466 (2d Cir. 1944)), which lay down the rule that the Commissioner may disregard the corporate entity, and impose taxes with regard to economic realities, where the corporation is sham or unreal by reason of having no other purpose than the effectuation of a tax saving. This rule, of course, will severely limit the use of the personal holding company bailout to situations where the taxpayer is able, for one reason or another, to invest HC with some substantial business function. The advisability of utilizing this form of bailout will be a decision to be made in each case by tax counsel thoroughly familiar with the client's business affairs, and only after the most cautious evaluation of the over-all situation.

A further difficulty with the personal holding company bailout is the immobility which it imposes. Once in place the holding company cannot be removed without incurring a tax, since the fair market value of the C stock will ordinarily exceed the adjusted basis of HC stock, and liquidation of the holding company will result in a capital gains tax.[10] Nor can C and HC be safely merged, either in a reorganization or a tax-free liquidation, without jeopardizing the bailout itself. Any such merger would be evidence of the absence of legitimate business purpose on the part of HC, and might also result in disregard of HC as an entity by application of the "step-transaction" rule (*Kimball-Diamond M. Co.*, 14 TC 74, off'd 187 T 2d 718 (5th Cir. 1951)).

Finally, additional tax cost will be incurred when it is desired to drain off current earnings of C, since such earnings must pass through HC and will thereby be taxed at the intercorporate dividend rate. This cost, however, will ordinarily be minimal. For example, if A is in the highest bracket, and desires to draw off $200,000 of C's earnings, the additional cost will amount to approximately $1,100.

General Considerations Limiting Bailouts

There are certain general considerations, in addition to the "business purpose" hazard, which will limit the utilization of the bailout procedures above described. Ordinarily, the use of a bailout involves preferred stock having a mandatory redemption feature. Such stock was used in the *Chamberlin* case. It was urged in the *Chamberlin* case, albeit without success, that such stock should not be treated as stock at all, but that its characteristics make it the equivalent of a debenture or other form of security. Additionally, the writer has elsewhere pointed to the possibility that stock carrying a mandatory redemption feature might well be excluded from the definition of "stock," as the term is used in the Code.[11] Should either of these contentions receive widespread judicial acceptance, then any form of bailout would be doomed to failure. The original distribution of the preferred would not qualify as a tax-free distribtuion of stock under Section 305(a), but would instead be a distribution of other property, and would be taxable as a dividend.[12] In any event, considerations of this character seemed to many to be the most potent obstacle to the bailout under former law; and, as such considerations go to the tax-free character of the original distribution, rather than to the mechanics of operation within the framework of Section 306, these theories must be regarded as a continuing threat to the success of any bailout proposal. ☆

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How the 1954 Code works in planning an estate today

by H. GENE EMERY *and* ROBERT S. ASHBY

Alert tax men have long since learned that all estate plans need careful scrutiny as a result of the new tax law. Here is a demonstration of how the provisions of the new Code affect insurance, annuities, endowments; the marital deduction and related estate planning matters. The discussion through income taxation of trusts and estates is by Mr. Emery; discussion of gifts to minors through to the end of the article is by Mr. Ashby

IN ORDER TO MAKE this discussion immediately useful and specific, we are using one set of facts for analysis of the several new provisions of the Code affecting estate planning. The facts are these.

The facts

Phil Black owns all of the stock in the Black Feed Company, Incorporated. He is 52, his wife, Marjorie, is 44, and they have two children, Sidney, 15, and Mildred, 12. Marjorie has no estate of her own. Phil's assets are as follows:

Assets	*Estimated value*	*Income tax basis*
Annuity (maturing at age 65)	$ 10,000	
Life insurance (cash value $21,400)	70,000	
20-year endowment—matured 10/29/54	10,000	
Home	28,000	$18,000
"E" bonds (joint with Marjorie)	2,600	
Listed stocks	1,000	1,500
Cash (joint with Marjorie)	4,000	
140-acre farm—possible residential property	55,000	30,000
Household goods	4,000	
Miscellaneous, including auto	5,000	
All stock in Black Feed Company	95,000	25,000
	$284,600	

Estate taxation of life insurance proceeds

THE PROBLEM: Phil has $70,000 of life insurance on his life, which he owns and on which he has always paid the premiums. The cash value is $21,400, and the net annual premiums are $1,180. What estate planning procedures can be applied to this insurance in view of the new Code?

THE LAW: Life insurance proceeds are no longer subject to estate tax in the insured's estate merely because he paid the premiums on the insurance policies. Under the new law, they are subject to estate tax in insured's estate only if:

1. The proceeds are payable to insured's estate, or
2. The insured has any incidents of ownership in the policy at the time of his death. (Sec. 2042 I.R.C. of 1954) (Applicable to decedent's dying after August 16, 1954.)

THE PRIOR LAW, in addition to either of above grounds, subjected proceeds to tax in insured's estate to extent insured had paid premiums on the policy, either directly or indirectly, during his lifetime. (Sec. 811(g) I.R.C. of 1939)

The possibilities

First possibility: Phil could give his existing insurance to Marjorie and continue to pay the premiums.

a. Phil would be making a gift to Marjorie of the replacement value (slightly more than the $21,400 cash value) of the policies. (Regs. 108 Sec. 86.19(i))

b. If Phil died within 3 years after making the gift, the gift would be presumed to have been made in contemplation of death. If the presumption were not rebutted, the death proceeds would be taxed in Phil's estate. (Regs. 105 Sec. 81.25)

c. If Phil retained a "reversionary interest" in the policies worth at least 5% of their value immediately prior to his death (probably the then replacement

value, cf. Regs. 108 Sec. 86.19(i)) the death proceeds would be taxed in his estate. (Sec. 2024 (2) I.R.C. of 1954)

(i) "Reversionary interest" is defined as a "possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate or may be subject to a power of disposition by him." (Sec. 2042(2) I.R.C. of 1954)

(ii) A mere possibility that Phil would inherit the ownership of the policies from Marjorie or that he would take them under her will, if she predeceased him, is not a "reversionary interest." (Cf. Rest. of Prop., Sec. 154 Comment (a); also cf. Report of the Comm. on Finance, U.S. Senate Report No. 1622, 83rd Cong. 2nd Session, page 124 together with Regs. 105, Sec. 81.17(c) and *Spiegel's Estate* v. *Comm'r.* (335 U.S. 703 (1947)).

(iii) But if Marjorie agreed, at the time of the transfer, that she would will the policies to Phil if she predeceased him, that could be held to be in effect the retention of a reversionary interest by Phil.

(iv) Only absolutely safe method of avoiding possible contention by government that reversionary interest exists is to provide for successor owners and beneficiaries other than insured to make certain that insured or his estate does not have one chance in twenty of receiving the ownership or the death proceeds.

d. Phil would lose the ownership of the lifetime values of his existing insurance, *i.e.*, right to cash the policies or borrow on them, or take a retirement income. So long as Marjorie remained alive these rights could be made available to him by Marjorie (if she would agree). But if she predeceased him, the ownership of the policies would have to pass to the children (to prevent ownership passing to Phil), who being minors could not exercise any of the lifetime options for the benefit of Phil.

Second possibility: Phil could keep his existing insurance in full force and Marjorie could take out new insurance on Phil's life upon which he could pay the premiums.

a. This would increase Phil's estate without increasing his estate tax.

b. This would, however, increase his premium load.

Third possibility: Phil could take paid-up insurance for his existing insurance while Marjorie could take out new insurance. Phil could pay the premiums on the new policy on his life taken out by Marjorie, either:

a. In an amount which would furnish the same net protection, as before, to Phil's family. For example:

Paid-up insurance on Phil's $21,400 cash value	$34,000
New insurance	29,200
Total gross protection	$63,200

Annual net premiums (considering all dividends) would be $980 as compared with $1,180 Phil is now paying—the elimination of the estimated 27% tax on the new insurance would result in the same net insurance, after taxes (assuming full marital deduction) as under the present set up.

b. In an amount which would result in same total premium cost to Phil as before. For example, here is how the figures work out:

Paid-up insurance on Phil's $21,400 cash value	$34,000
New insurance	34,000
Total gross protection	$68,000

Annual net premiums (considering all dividends) would be $1,180 (same as under present set up). The elimination of the estimated 27% estate tax on the new insurance would result in a $4,800 increase in the net insurance proceeds, after taxes passing to Phil's family (assuming full marital deduction).

c. There would be no gift from Phil to Marjorie. This would eliminate any gift tax problem, or gift in contemplation of death issue.

d. Phil would retain control over the paid-up insurance. (Cf. the possibility of Marjorie purchasing low-premium insurance, furnishing death protection only. Such low premium insurance, *i.e.*, term insurance, having little or no cash value, would not result in any added value to be taxed in the insured's spouse's estate if she should predecease the insured.)

e. Even though Phil had never owned the new policy, the definition of reversionary interest in Sec. 2042(2) is so broad that it would include a possibility of his reversionary ownership of new policy (or of his estate receiving proceeds), so this possibility must be eliminated.

Income taxation of life insurance proceeds left with the insurer under an optional method of settlement

THE PROBLEM: Phil's insurance could be paid to his beneficiaries either in a lump sum, or under one of the optional methods of settlement, or with the beneficiary having the right to select the method of settlement. From the tax standpoint, how should the proceeds be payable? What are the practical aspects?

THE LAW: *Where life insurance proceeds* are taken by surviving spouse under one of the *installment or life income* options, the first $1,000 of interest received each year is excluded from the surviving spouse's gross income. Interest received on proceeds left on the straight interest option is all taxable. (Sec. 101(d) I.R.C. of 1954)

Regulations and Tables for use in determining the proportion of interest and returning in each year's payment are to be issued by the Commissioner.

Payments of interest where payments began prior to August 16, 1954 (the death of the insured being prior to that date) are governed by the old rule. (Sec.

101(f) Internal Revenue Code of 1954.)

PRIOR LAW excluded *all* interest received by *any* beneficiary under installment or life income optional methods of settlement. (Sec. 22(b)(1) I.R.C. of 1939; Regs. 118 Sec. 39.22 (b)-1)

The possibilities

First possibility: The insurance could be made payable to Marjorie on the straight interest option. Bad from tax *and* liquidity standpoint.

Second possibility: All or a part of the insurance could be made payable to children on one of the options other than the interest option; but the exclusion does not apply to beneficiaries other than the surviving spouse.

Third possibility: If the proceeds were left to Marjorie in a lump sum or on such option as she might elect, she could take in a lump sum such part of the proceeds as needed to help the estate pay settlement costs and leave the balance on one of the options to which the annual $1,000 exclusion is applicable.

Fourth possibility: The amount of interest in each year's payments under one of the options to which the exclusion is applicable will depend upon:

a. The gross amount of the insurance proceeds.

b. The period over which payments are to run, *i.e.*, life, life with so many months certain, or installments for so many months.

c. The guaranteed interest rate under the policy.

It is impossible therefore to make any blanket statement as to how much insurance can be left to the surviving spouse without any part of the optional payments being subjected to income tax. Under the tentative regulations which have been issued (Par. 10001 C.C.H. Pension & Profit Sharing Guide), $54,600 of insurance could be left to a spouse aged 55, on a life income 20-year certain option, guaranteed interest rate 2 1/2%, and the spouse would receive approximately $1,000 yearly in interest.

Income taxation of life insurance policies which have been transferred for value

THE PROBLEM: Suppose that in some subsequent year Phil, although then uninsurable, wants the Black Feed Company to carry some key-man insurance on his life. Could he transfer some of his existing insurance to the corporation, for its then cash value, without any adverse tax consequences?

THE LAW: *A transfer of a life insurance policy* for a *valuable consideration* will not result in the death proceeds being subject to income tax, if the transfer is to (1) the insured, (2) insured's partner, (3) the partnership of which insured is a partner, (4) corporation of which insured is a shareholder or officer, or (5) if policy's income tax basis carries *over* to transferee, *i.e.*, a tax-free exchange. (Sec. 101(a)(2) I.R.C. of 1954)

PRIOR LAW taxed difference between death proceeds, and sum of consideration plus subsequent premiums paid by transferee, except where transfer was (1) to insured, or (2) where policy's income tax basis carried over to transferee. (Sec. 22(b)(2)(a)I.R.C. of 1939)

THE EFFECT: Phil would be able to transfer some of his insurance for value, to the corporation without subjecting the death proceeds of the policy to income tax.

Income taxaton of amounts received on surrender of a policy

THE PROBLEM: Suppose that Phil, at some time in the future, wants to cash in some of his existing life insurance. What will the income tax effect be?

THE LAW: *The excess over cost* of any amounts received, other than as an annuity, upon the surrender of an annuity, endowment or life insurance contract, are taxed as ordinary income to the recipient, but the tax due to the inclusion of such excess in income shall not be greater than if it had been received 1/3 in the taxable year and 1/3 in each of the two preceding years. (Sec. 72(e) I.R.C. of 1954)

PRIOR LAW did not permit the income to be spread over three years, taxing it all in the year of receipt. (Sec. 22(b)(2)(A) I.R.C. of 1939)

THE EFFECT: Assuming the total premiums paid by Phil on the policy to be cashed were $15,000 and the surrender value was $18,000, the $3,000 difference would be ordinary income. Phil would have the option of taking the entire $3,000 into income in the year of surrender and paying his tax for that year on such a basis, *or* he could treat it as if $1,000 had been received in the year of receipt and $1,000 in each previous year and compute the total tax on the $3,000 on that basis.

Income taxation of annuity receipts

THE PROBLEM: When Phil's pure annuity matures at age 65, he will have paid $20,000 in premiums for it and will receive $1,460 yearly in payments, for the balance of his life. His life expectancy at age 65 will be 15 years. How will he be taxed on the receipts?

THE LAW: *Annuity Receipts* are taxed under a "life expectancy" rule: the cost of the annuity is divided by the expected return under the annuity (annual payments multiplied by annuitant's life expectancy) to determine tax-free portion of each year's receipts. Such portion remains tax-free throughout the lifetime of the annuitant, and the remainder of each years' re-

ceipts is taxable as ordinary income. (Sec. 72 (b) I.R.C. of 1954)

1. Joint and survivor and refund annuities will be taxed under the same general rule. (Sec. 72(c) I.R.C. of 1954)

a. Value of refund feature is to be deducted from cost in accordance with regulations to be issued by Secretary.

b. Joint expectancy of joint annuitants to be computed in accordance with tables to be issued by Secretary.

2. Annuities upon which payments were being received on June 1, 1954, are taxed as to all subsequent receipts under the new rule with their cost being diminished by all receipts previously received tax-free under the prior 3% rule. (Secs. 72 (c)(1)(B) and 72 (c)(4) I.R.C. of 1954)

PRIOR LAW taxed annuity receipts under the 3% rule, treating that portion of each year's receipts equal to 3% of the cost as interest (taxable) and the balance as returning principal (nontaxable) until the tax-free receipts equalled the cost. Thereafter, all receipts were taxable. (Sec. 22(b)(2)(A) I.R.C. of 1939)

THE EFFECT:

Cost	$20,000
Annual payment beginning at 65	$ 1,460
Life expectancy	15 yrs.

	New life Expectancy rule	*Old 3% rule*
Taxable portion first year	$ 127	$ 600
Total taxable after 10 years	$ 1,270	$ 6,000
Total taxable after 15 years	$ 1,905	$ 9,000
Total taxable after 20 years	$ 2,540	$12,000
Non-taxable portion first year	$ 1,333	$ 860
Total nontaxable after 10 years	$13,330	$ 8,600
Total nontaxable after 15 years	$19,995	$12,900
Total nontaxable after 20 years	$26,660	$17,200
Cost recovered tax-free after	15 yrs.	23 yrs.

(These figures are based on a single premium pure annuity purchased from one of the first line mutual insurance companies at age 65 and are not precisely correct for the annual premium type of annuity which Phil owns. However, they are used here merely to illustrate the effect of the new rule.)

Income taxation of endowment proceeds

THE PROBLEM: Phil's $10,000 endowment (which cost him $8,800) matured on October 29, 1954. He does not want to take the endowment proceeds in cash, but wants to take them as an annuity for the balance of his lifetime. He has not notified the insurance company of this desire. What is the income tax effect?

THE LAW: The excess of endowment proceeds, when received in a lump sum, over cost, is taxed as stated above. However, if the owner of an endowment elects to receive the proceeds within 60 days after maturity, under an annuity or installment option, he is not taxed on the excess of proceeds over cost, in the year of maturity, but is taxed on the payments as received under the annuity method. (Sec. 72(h) I.R.C. of 1954)

The new provision applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954. (Sec. 7851 (a)(1) (A) I.R.C. of 1954)

PRIOR LAW treated the endowment proceeds as "constructively received" (with the excess of the proceeds over cost taxed as ordinary income) in the year of maturity, unless the election to receive the proceeds under an optional method of settlement had been made prior to the maturity date. (I.T. 3963, CB, 1949–2, 36)

THE EFFECT: Phil will have until 60 days after the maturity date (October 29) within which to notify the insurance company of his election to take the endowment proceeds under the annuity option rather than as a lump sum. In computing his tax under the annuity life expectancy rule, his cost for the annuity will be the total premiums ($8,800) paid for the endowment rather than the gross endowment proceeds ($10,000).

Summary

Our recommendations and advice to Phil would be:

1. Phil should take paid-up life insurance of $34,000 on his life; Marjorie should take out $34,000 of new ordinary life insurance on Phil's life upon which Phil could pay the premiums.

2. All of the insurance should be made payable to Marjorie so that she may elect to take the proceeds either in a lump sum or on one of the optional methods of settlement.

3. Should it ever become advisable, Phil could transfer any of his existing life insurance to his corporation, for value, without there being any adverse income tax effects.

4. If Phil ever cashes an insurance policy and receives more than cost for it, the excess over cost can be treated as if received $^1/_3$ in each of 3 years.

5. When Phil's annuity matures, the receipts will be taxed under the "life expectancy" rule.

6. If Phil elects to receive his endowment proceeds under the life income option by December 27, 1954, he will not be taxed in 1954 on the excess of the endowment proceeds over cost.

ESTATE TAX MARITAL DEDUCTION

Legal life estate with power of appointment

THE PROBLEM: Phil has a 140-acre farm worth $55,000. If it is impractical to leave the farm outright to Marjorie or in a marital deduction trust for her, is there any other method of leaving the farm to her so that it will qualify for the marital deduction?

THE LAW: *The marital deduction* is allowed for a *legal life estate* in property left to the surviving spouse with the remainder interest subject to the surviving spouse's general power of appointment. (Sec. 2056-(b)(5) I.R.C. of 1954)

PRIOR LAW allowed no such deduction (cf. Sec. 812-(e)(1)(F) I.R.C. of 1939)

The possibilities: The farm can be qualified for the marital deduction by:

1. Leaving it outright to Marjorie, or
2. Leaving it in a "marital deduction" trust. (Sec. 2056(5) I.R.C. of 1954)
3. Leaving Marjorie a legal life estate, remainder to her estate (Sec. 2056(b)(1)(A). Although not generally known, this was also true under the previous law. Although the life estate is a "terminable interest," it is not objectionable since no interest in the property passes to anyone other than the estate of the surviving spouse at her death. The deduction is and always has been allowed for the entire value of the property. (Regs. 105, Sec. 81.47a (b)(2))
4. Leaving Marjorie a legal life estate, remainder subject to her general power of appointment.

The foregoing is true of all types of property—the farm is used merely as an illustration.

Marital deduction trust

THE PROBLEM: Suppose that Phil wants Marjorie to have the income from all of his property for life, yet he also feels that he would like her to have assistance in the management of that property, *i.e*, a trustee. He also wants his estate subjected to minimum estate taxes in passing to his children. How many trusts must he create?

THE LAW: *The marital deduction* is allowed for a specific portion of trust property, if the income from such portion goes to the surviving spouse for life and she has a general power of appointment over such specific portion. (Sec. 2056(b) I.R.C. of 1954)

PRIOR LAW allowed a deduction for trust property only if the surviving spouse received the income from the *entire* trust and had a general power of appointment over the *entire* trust corpus. (Sec. 812(e)(1)(F) I.R.C. of 1939)

The Possibilities

1. Phil could leave one-half of his adjusted gross estate to a "marital deduction" trust from which Marjorie would receive all the income and over which she would have a general power of appointment. This trust property would qualify for the marital deduction. He could leave the balance of his estate to another trust, the income from which would go to Marjorie for life, but over which she would have no general power of appointment. This trust property would not be taxed at her later death.

This was the standard procedure under the previous law and can still be done.

2. Phil could leave all of his estate to a single trust. Marjorie could be given the income from, and a general power of appointment over, a "specific portion" of the trust property equal to one-half of Phil's adjusted gross estate. That portion would qualify for the marital deduction. She would get the income from the balance of the trust, but would have no rights over the corpus of such balance. The balance would not be subjected to a "second estate tax" at her death.

Before using a single trust, however, these problems must be carefully considered:

a. What is a "specific portion" of the trust property?

(1) Will a dollar amount be a "specific portion?"

(2) Will certain items of property which are singled out by the draftsman as marital deduction property be a "specific portion?"

(3) Will a fractional amount be a "specific portion?"

b. If it is desired to qualify exactly one-half of the adjusted gross estate, and no more, a formula clause might be used in the trust, giving the surviving spouse the income from and a general power of appointment over trust property equal in value to one-half of the adjusted gross estate as finally determined for federal estate tax purposes.

c. If the surviving spouse is given the income from, and a general power of appointment over, a specific dollar amount in the trust, any increase or decrease in the value of the trust assets between the deaths of the two spouses would be reflected in the non-marital deduction portion of the trust. Cf. effect on estate tax of surviving spouse at her subsequent death.

3. At least until the regulations are issued, prudence calls for the use of two separate trusts.

Summary

Our recommendation to Phil would be: Considering his desire that Marjorie have the advice and assistance of a trustee, in so far as possible, in respect to the property he leaves to her; he should:

1. Establish two trusts in his will.
2. One trust will be a marital deduction trust to which will pass sufficient property to result in the qualification of one-half of his adjusted gross estate for the marital deduction.
3. The residue of his estate will pass to a second trust, from which Marjorie will receive the income for life, but over which she will have no general power to invade or appoint the corpus.

INCOME TAXATION OF TRUSTS AND ESTATES

THE PROBLEM: Since Phil's children are now minors and might be minors at the time of the death of the

survivor of Phil and Marjorie, his will should provide for the holding of all of his property in a trust for those minor children. While the children are still minors, it will be desirable for the trust to give the Trustee discretion in the use of income for the children and to provide for the accumulation of all income not so used.

When we asked Phil about the dates for the ultimate distribution of principal (and accumulated income) to the children, his first thought without any detailed consideration on his part was that one-half of each child's share of the principal (and accumulated income) should go to him at 22 and the balance at age 25.

What effect will the Revenue Code of 1954 have upon this situation?

THE LAW: *Trusts* are divided into two classes for purposes of income taxation under the Internal Revenue Code of 1954.

"*Simple Trusts*" are those trusts which are required to currently distribute all of their income to their beneficiaries. The general rule is that all income distributed by the trust is deductible by the trust, and all such distributed income is taxable to the beneficiaries. (Secs. 651 and 652 I.R.C. of 1954)

"*Complex Trusts*" are those trusts which in any taxable year provide for the accumulation of some income, or for the distribution of some corpus or previously accumulated income. (Since the primary function of an estate is to distribute corpus, estates are taxed under the complex trust rule.) The general rule is that all income distributed by the complex trust is deductible by the trust and is taxed to the beneficiaries, while all income which is accumulated is taxed to the trust. (Sec. 661 and 662 I.R.C. of 1954)

However, under certain circumstances accumulated income may be taxed to the beneficiaries. This will be so to the extent that the "*five-year throw back rule*" is effective. (Sec. 668 I.R.C. of 1954)

Under the five-year throw back rule any distribution by a trust (with certain specified exceptions hereinafter mentioned) in excess of the distributable income for its current year is "thrown back" first to the preceding year to the extent that there was undistributed net income in that year, and then to each preceding year, to the extent of undistributed net income in those years, for no more than five previous years in total. To the extent undistributed net income exists in those five previous years, the beneficiary is taxed in the current year on the amount he receives, whether he receives principal or accumulated income or both. There are five exceptions to the application of this rule to a complex trust and its beneficiaries (it does not apply to estates):

1. Accumulations paid to a beneficiary upon his reaching 21 are not "thrown back."

2. Distributions "to meet the emergency needs" of a beneficiary are not "thrown back."

3. Accumulations paid upon a beneficiary's reaching a specified age or ages, if
   a. The total distributions to a beneficiary do not exceed four in number, and
   b. The period between each distribution is four years or more,

are not "thrown back."

4. Final distributions if made more than nine years after the date the last property was transferred to the trust are not "thrown back."

5. Distributions *not* exceeding the current year's distributable income by more than $2,000 are not "thrown back."

PRIOR LAW treated all types of trusts and estates under one set of rules which in general allowed a trust or estate to take a deduction for the income distributed to the beneficiaries and taxed such income to the beneficiaries; and taxed to the trust or estate all accumulated income. Instead of the "five-year throw back rule," the distribution of accumulated income was taxed under the "twelve month" and "sixty-five day" rules. (Sec. 162 I.R.C. of 1939)

THE EFFECT:

1. Assuming that the children are still minors after the death of the survivor of Phil and Marjorie, the trust should provide for the accumulation (during minority) of the income that they do not need. Phil's first thought was to have the principal, which would include the accumulated income, paid out to each child one-half at age 22, and one-half at age 25.

2. However, since neither of these distributions (except possibly the final distribution at age 25, if it turns out to be more than nine years after the date the last property was transferred to the trust by Phil or Marjorie) comes within any of the above exceptions, if either distribution exceeds $2,000, it would be "thrown back" for the five years preceding the distribution to the extent of undistributed net income in any of those five years and to that extent would be taxed to the beneficiary.

3. Thus, the distribution to each child at age 22 would be "thrown back" to the four years prior to that child's reaching 21 when some income would have in all probability been accumulated for him and to the extent of those accumulations would be taxed to him rather than the trust.

4. The distribution at age 25, assuming it turns out to be not more than nine years after the date of the last transfer of the property to the trust by Phil or Marjorie, would be "thrown back" to the five preceding years. However, there would have been no accumulated income in the four years while the child was between the ages of 21 and 25 so there would be only one year in which there would have been any undistributed net income, *i.e.*, the year while the child was 20. However, that undistributed income would have

already been absorbed by the "throw back" from the distribution at age 22, so the "throw back" from the distribution at age 25 would have no effect.

5. Assuming that from a tax standpoint it is desirable to have part of the trust income taxed to the trust and part of the income taxed to the beneficiary, care must be taken in drafting trusts to assure that distributions will come within one of the exceptions to the "throw back rule."

Summary

We recommended to Phil:

1. That the trust provide for principal distributions to the children with each child getting one-half of his share at the age of 22 and the balance at the age of 26 so that there will be four year period separating the distribution dates.

2. Thus, by virtue of the third exception above, neither of the distributions would be "thrown back."

Gifts to minors utilizing the annual exclusion

THE PROBLEM: Should Phil consider making gifts to his two minor children, Sidney and Mildred, out of his current income or from his accumulated property? If gifts are to be made, should they be made outright and guardians be appointed for the children, or should the gifts be made in trust?

THE LAW: Under the gift tax law there is an annual exclusion of $3,000 per donee ($6,000 for a husband and wife filing a joint gift tax return or a return and consent) for gifts of present interests (1954 Code, Sec. 2503(b)). This exclusion is not available for gifts of future interests. Under the 1954 Code, Sec. 2503(c), a gift in trust for a minor is not a future interest "if the property and the income therefrom (1) may be expanded by or for the benefit of the donee before attaining the age of 21 years, and (2) will, to the extent not so expended pass to the donee on his attaining the age of 21 years, and in the event the donee dies before attaining the age of 21 years may be payable to the estate of the donee or as he may appoint under a general power of appointment . . . ."

If Phil decides to make gifts to his minor children it will be advantageous for him to make such gifts by way of trust rather than by use of a guardianship because:

1. The trust need only provide that the income *may* be expended for the benefit of the donee. Discretionary accumulation is therefore possible, providing a new taxpaying entity taxable at a lower rate than if taxed as a part of a minor's earned or other income.

2. Freedom from court accountings and greater flexibility of investment can be obtained by the use of a trust.

3. Upon termination of the trust and payment of accumulations at age 21, accumulations will be received tax free. The five-year throw back rule does not apply to distributions of accumulated income payable upon attainment of age 21 (1954 Code, Sec. 665(b)).

The trust instrument should provide that principal and accumulated income should be payable to the estate of the minor child in event of his death prior to age 21. This will satisfy the statutory requirement for payment to the estate of the minor *or* as he may appoint under a general power of appointment. There is doubt that a minor can exercise a power of appointment by deed. *Restatement of Property, Sec. 3451.* Cf. *Simes Future Interests, Sec. 268.* Consequently, the sure way to avoid uncertainty and to qualify under the statute is to provide for payment to the minor's estate in event of his death.

Whether a trust or a guardianship is used, the minor will not be lost as a dependent. Whether income is paid to him, accumulated for him, or distributable to him, he will continue to be a dependent of his parent if such parent provides over one-half of his support and the minor is under the age of 19 or is a student. 1954 Code, Sec. 151(e).

Elimination of basis disadvantages with gifts in contemplation of death

THE PROBLEM: Should Phil refrain from making gifts to his wife or children because of the possibility that such gifts may be in contemplation of death? Will the possible income tax disadvantages of such gifts outweigh their possible estate tax advantages?

THE LAW: Gifts made three years or more prior to death of the donor *cannot* be in contemplation of death and consequently cannot be included in the donor's estate for federal estate tax purposes as gifts in contemplation of death (except in the case of decedents dying prior to September 23, 1953). Gifts made within three years of death are deemed to be in contemplation of death, but the contrary may be shown. 1954 Code, Sec. 2035(b)

Even if property is included in the donor's estate for estate tax purposes as a gift in contemplation of death, it will take a new basis equal to its valuation for estate tax purposes. 1954 Code, Sec. 1014(b)(9)

If property is included in the donor's estate as a gift in contemplation of death, the gift tax paid ordinarily may be used as a credit against the estate tax. 1954 Code, Sec. 2012

The former disadvantage attaching to gifts in contemplation of death is removed by the new law. There is no longer any danger that appreciated property found to have been given in contemplation of death will be taxed as a part of the donor's estate but still obtain no stepped-up basis to the value at which it was taxed in the donor's estate.

With respect to the property which is given away by gifts not in contemplation of death, there is a carryover of the donor's low basis (1954 Code, Sec. 1015(a)). A stepped-up basis results only if the property

is included in the donor's estate for federal estate tax purposes. The new law merely removes the possibility that a gift will be taxed under the federal estate tax at a high value and at the same time for income tax purposes will remain saddled with a low basis.

Gifts now made by Phil are unlikely, at his age to be considered to be in contemplation of death. If these gifts are not in contemplation of death, the donee will take Phil's basis for federal income tax purposes. Other things being equal, Phil should not make gifts of properties which have a value greatly in excess of their basis. Such property should be retained to obtain a stepped-up basis in Phil's estate.

Use of tenancies by the entirety in estate planning

THE PROBLEM: Phil owns two pieces of real estate, a farm having a value of $55,000 and a residence having a value of $28,000. Should either of these pieces of real estate be transferred to Phil and Marjorie as tenants by the entirety?

THE LAW: Under the new law, the creation of a tenancy by the entirety in real estate on or after January 1, 1955, is not treated as a gift unless the parties elect to have it so treated. 1954 Code, Sec. 2515

Subsequent sale of the property will involve no gift from one spouse to the other unless the proceeds of the sale are divided between the spouses disproportionately to their original contributions for acquisition of the property. 1954 Code, Sec. 2515(b)

Property held as tenants by the entirety will be included in the estate of the donor upon his death. 1954 Code, Sec. 2036. But property so held will automatically qualify for the marital deduction. 1954 Code. Sec. 2056(a)

Property held as tenants by the entirety and taxed to the estate of the donor for federal estate tax purposes, will take a new basis for federal income tax purposes whether or not an election is made to treat the creation of the tenancy by the entirety as a gift. 1954 Code, Sec. 1014(b)(9)

Provisions exempting the creation of a tenancy by the entirety from gift tax apply only to tenancies by the entirety created on or after January 1, 1955. 1954 Code, Sec. 7851(a)(2)(B)

Provisions granting a stepped-up basis for property held as tenants by the entirety, but taxed as a part of a deceased tenant's estate, apply in the case of decedents dying after December 31, 1953. 1954 Code, Sec. 1014(b)(9)

With respect to transfers creating tenancies by the entirety on or after January 1, 1955, the new law makes it possible to avoid gift tax liability. Liabilities already existing under the old law in connection with the creation of a tenancy by the entirety are not affected. For a statement of the old law see *Lilly* v. *Smith, Collector,* 96 F. 2d 341 (7th Cir., 1938); cert. denied 305 U. S. 604. The old law still applies with respect to creation of joint tenancies in personal property.

The parties can elect to have the creation of a tenancy by the entirety treated as a gift from one spouse to the other. Circumstances in which such election will be desirable are extremely rare. Treating the transaction as gift will not remove the property from the estate of the donor for federal estate tax purposes. Since a husband and wife may split their income, there is no income tax advantage in electing to treat the transfer as a gift. In very unusual circumstances, there may be an advantage in electing to have such a tenancy treated as a gift, paying a gift tax thereon, and using the gift tax paid as a credit against the estate tax under Sec. 2012. (The gift tax paid will escape estate tax.) Certainly Phil should not elect to have any tenancy by the entirety created by him treated as a gift.

The former income tax disadvantage to creation of a tenancy by the entirety is removed. If Phil creates a tenancy by entirety in the farm, upon his death the farm will be included in his estate and will obtain a stepped-up basis for federal income tax purposes equal to its value for federal estate tax purposes, *i.e.* $55,000. (Under the old law Marjorie would have had to use the original basis, $30,000.)

Phil may consider using a tenancy by the entirety with respect to the farm or his residence, or both, if local law provides that upon his death the property will pass to Marjorie free from state inheritance tax.

Such property would not be included in the probate estate and hence will pass with little or no cost of administration, and such property will be free from the claims of individual creditors of the husband and wife in the meantime.

The property passing from Phil to Marjorie on Phil's death by reason of the existence of a tenancy by the entirety will automatically qualify for the marital deduction. Consequently, the use of a tenancy by the entirety provides a means of (a) keeping property out of the probate estate, (b) qualifying it for the marital deduction, and (c) exempting it from the state inheritance tax in some states. This technique can be used only with respect to real estate. The creation of a joint interest in personal property, *e.g.*, the Black Feed Company stock, even under the new law will constitute a gift under Sec. 2051(a), 1954 Code.

Property transferred so that possession takes effect after death

THE PROBLEM: Should Phil make intervivos transfers "to take effect in possession or enjoyment at or after death?" In other words, is it feasible for Phil to get property out of his estate but to delay enjoyment of such property by its beneficial owners until Phil's death?

THE LAW: Under the new law property is not in-

cluded in the transferor's estate merely because possession or enjoyment can be obtained only by surviving the decedent (1954 Code, Sec. 2037(a)(1)). To be included, the grantor must reserve a reversionary interest (1954 Code, Sec. 2037(a)(2)), or retain a life estate (1954 Code, Sec. 2036).

Under the new law it is possible to exclude from a decedent's estate property which the transferor is willing irrevocably and completely to give up but which he does not wish his children or other beneficiaries to enjoy until his death.

The trust instrument should not provide that accumulations of income be used for the purchase of insurance upon the life of the grantor. Such a provision will result in taxation to the grantor of the income "applied to the payment of premiums on policies of insurance on the life of the grantor" under the 1954 Code, Sec. 677.

Income can be accumulated, and if accumulations are added to principal and no distribution of them is made for five years following the death of the grantor, difficulties under the five-year throw back rule, discussed supra page 87, will be avoided. An income tax advantage will be obtained since the income will be taxed to the trust presumably at rates lower than those applicable to the grantor or his prospective beneficiary. This asumes that there is no violation of the *Clifford* rules, discussed below.

The Clifford Trust rules

THE PROBLEM: In creating any intervivos trust, whether for minors or for adult beneficiaries, careful consideration must be given to the so-called *Clifford Trust* rules, which were formerly embodied in the regulations, and which now, with minor changes, are written into the statute. The consequence of infringement of these rules is that the income of such trust will be taxed to the grantor.

THE LAW: The statute sets up five tests, *violation of any one of which* will result in an inclusion of the income of an intervivos trust in the income of the grantor for income tax purposes. These tests frequently turn on whether a person is an "adverse" party. An adverse party means "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of a power" (1954 Code, Sec. 672(a). The five tests are:

1. *Forbidden Reversionary Interests.* If the duration of the interest given is shorter than ten years or may be shorter than ten years, income will be taxed to the grantor (Sec. 673(a)), unless the income is payable to a charity (Sec. 673(b)), or unless the trust is to endure during the life time of the beneficiary (Sec. 673(c)).

2. *Forbidden Power to Control Beneficial Enjoyment.* If the grantor reserves to himself or grants to a non-adverse party rights to control beneficial enjoyment, the income will be taxed to him regardless of the duration of the trust (Sec. 674(a)). Note that this will be true even though the right to control beneficial enjoyment is not vested in the grantor if it is vested in a non-adverse party. The following powers to control beneficial enjoyment are not objectionable: powers relating to a period more than ten years after the creation of the trust (Sec. 674(b)); certain powers exercisable only by will (Sec. 674(b)(3)); power to allocate among charitable beneficiaries (Sec. 674(b)-(4)); power to distribute corpus provided there is a reasonably definite standard set forth in the trust instrument (Sec. 674(b)(5)); power to withhold income temporarily (Sec. 674(b)(6)); power to withhold income during disability of a beneficiary (Sec. 674(b)(7)); and power to allocate between corpus and income (Sec. 674(b)(8)). Exceptions are also made if independent trustees are empowered to accumulate income or allocate it among a class and afterborn members may be added to the class (Sec. 674(c)). Further exceptions are made if powers to allocate are limited by a definite standard (Sec. 674-(d)).

3. *Forbidden Administrative Powers.* If the grantor reserves certain administrative powers, the income of the trust will be taxed to him whether such administrative powers vest in him or in a non-adverse party (Sec. 675). The forbidden powers include (1) power to deal for less than adequate and full consideration (Sec. 675(1)); (2) power to borrow without adequate interest or security (Sec. 675(2)); (3) if the trust funds have been borrowed directly or indirectly by the grantor and not repaid before the end of the year (Sec. 675(3)); (4) general powers of administration exercisable in a non-fiduciary capacity; including voting powers which "are significant from the viewpoint of voting control," investment powers which affect holdings which are "significant from the viewpoint of voting control," and powers to reacquire the trust corpus by substituting other property of equivalent value (Sec. 675(4)).

4. *Forbidden Powers of Revocation.* The grantor will be taxed on the income of a trust if he has reserved a power in himself or in a non-adverse party to revoke the trust and to so regain beneficial ownership (Sec. 676(a)).

5. *Forbidden Rights to Income.* The grantor will be taxed on the income if he reserves to himself or to a non-adverse party certain powers over the income of the trust, including the power to cause them to be distributed to the grantor, to be accumulated for the grantor or used to pay insurance premiums on the life of the grantor, or to the extent the income of the trust is *actually* used for the support or maintenance of a beneficiary the grantor is legally obligated to support (Sec. 677). There are exceptions if such rights are not exercisable for ten years for periods while they are not exercisable (Sec. 677(a)).

The importance of these provisions is largely negative. Frequently trusts which on their face seem harmless will fall afoul of these provisions. It is important, therefore, that every intervivos trust be checked carefully against these provisions to be sure that the income from such trusts will not be taxable to the grantor.

Most attempts which run afoul of these provisions will involve irrevocable trusts. Hence the damage done by disregard of the rules is likely to be irreparable.

Suppose Phil gives Black Company stock to a trust for his minor child, but reserves a right to buy it back at its fair value to be fixed by disinterested experts. The income will be taxed to Phil under Sec. 675(4), although all other tests laid down by the *Clifford* rules are met.

Redemption of stock for payment of estate taxes

THE PROBLEM: The Black Feed Company has a Sec. 102 problem (1954 Code, Sec. 531). Phil Black is anxious, if possible, in event of his death, to raise the funds necessary for payment of estate taxes on his estate out of the corporation. This would provide his estate with liquid funds and at the same time alleviate the problem of the corporation. He would like to do all this without paying ordinary income tax on dividends from the corporation. The stock of Black Feed Company in his estate at its present valuation equals about 33% of his prospective gross estate.

THE LAW: Under the new law, Black Feed Company stock may be redeemed without such redemption being treated as a dividend if such stock constitutes 35% of the decedent's gross estate or 50% of his taxable estate. 1954 Code, Sec. 303(b)(2)

Under the new law, the amount of such redemptions may equal all death taxes and interest thereon, funeral and administration expenses allowable as deductions for Federal estate tax purposes. 1954 Code, Sec. 303(b)(2)

Even if the stock redeemed is tainted stock under Sec. 306, redemption will be possible without receipt of ordinary income by the estate to the extent permitted by this section.

The redemption or redemptions must occur within the period for assessment of the Federal estate tax or within ninety (90) days after the expiration of such period, or within sixty (60) days after a decision of the Tax Court in event a deficiency is determined to be due in a Tax Court proceeding. 1954 Code, Sec. 303(b)(1)

If the decedent owned more than 75% in value of the outstanding stock of each of two or more corporations, the 35% and 50% requirements can be applied as if the two or more corporations were a single corporation. 1954 Code, Sec. 303(b)(1)(B)

The new law applies to taxable years beginning after December 31, 1953. 1954 Code, Sec. 7851(a)-(1)(A)

Since the Black Feed Company stock constitutes only 33% of the decedent's prospective gross estate, redemption under this section will not be possible under the 35% of gross estate limitation. However, if the full advantage is taken of the marital deduction, the taxable estate will be reduced by approximately one-half to $142,300, and the Black Feed Company stock will have a value in excess of 50% of that amount. Redemption will, therefore, be possible under Sec. 303(b)(2)(A)(ii). In making such redemption it will be immaterial whether the stock redeemed passes to the widow as property qualified for the marital deduction or is disposed of elsewhere. It is only required that the stock be "included in determining the gross estate of the decedent."

If Marjorie dies before Phil, no marital deduction will be available. Phil's taxable estate will then be of such size that neither the 35% nor the 50% limitations can be met. In order to qualify, Phil may have to argue that the Black Feed Company stock is worth more than he originally thought. Alternatively, he may meet the requirements for the redemption by making gifts which will reduce his gross estate to a point that the 35% limitation will apply.

The provisions of the old law limiting redemption to an amount not in excess of estate "inheritance, legacy and succession taxes, including interest" (1939 Code, Sec. 115(g)(3)), has been broadened to include funeral and administration expenses allowable as deductions (1954 Code, Sec. 303(a)(2)). Phil may be able to take out a substantial amount, therefore.

There is no requirement that the proceeds of redemption be actually used or even that they be needed for the payment of death taxes and administration expenses, although the amount of such redemption cannot exceed the amount so expended.

Such distributions need not be in cash. The statute refers to a distribution of property. There is, therefore, the possibility of getting tangible assets as well as cash out of a corporation in this way. Such distribution would involve no gain to the corporation (1954 Code, Sec. 311(a)). Hence the stockholder could in one transaction get a stepped-up basis for a low basis asset and get it out of the corporation without realization of ordinary income or capital gain.

The fact that a redemption may not be possible under Sec. 303 still may not preclude a tax-free redemption even of stock which in the hands of the decedent was Sec. 306 stock. It may be possible to redeem stock from the estate without receipt of dividend income under Sec. 302(b)(3) relating to a complete termination of the shareholder's interest or by means of a substantially disproportionate redemption of stock. 1954 Code, Sec. 302(b)(4) and Sec. 302(b)(2) ✯

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

Investment bankers see unfair tax advantage in proposed variable annuity

IF THE VARIABLE ANNUITY is made legal the insurance company salesman would be able in effect to offer a diversified common stock investment but on a basis which would offer a very distinct tax advantage over direct investment in common stocks, in that under the tax laws income earned on annuity premium payments may be reinvested tax free during the life of the contract. In short, the beneficiary of an annuity could have common stock dividends reinvested tax free all during the life of the annuity contract and would, in the opinion of the proponents of the bill, be subject to taxes only on some portion of his annuity income when paid to him. This is what Robert L. Osgood told Investment Bankers Association recently. Mr. Osgood, who is chairman of that group's Investment Companies Committee, is with Vance, Sanders & Co., Boston.

"As a company which would be subject to regulation only under insurance laws," he continued, "the sale of common stocks in the form of an annuity would be exempt from all federal and state securities regulation as well as regulation by the exchanges and the National Association of Securities Dealers."

A bill was passed by the New York State legislature in 1954 authorizing the establishment of variable annuities but it was vetoed by the Governor. Informed quarters expect the bill to be reintroduced in 1955.

Definition of a variable annuity

The purpose of the variable annuity is to protect the annuitant against the declining purchasing power of the dollar. This is to be accomplished by giving the purchaser of the annuity an undivided interest in holdings of a diversified list of common stocks.

Tax status of annuity payments

The general tax status of life insurance companies and annuity payments is as follows:

1. Life Insurance Companies. For the past three years life insurance companies have been taxed under temporary provisions at a flat rate of $3^3/_4\%$ on the first $200,000 and $6^1/_2\%$ on amounts in excess of $200,000 of net investment income with certain adjustments. The definition of a life insurance company is "an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance)" and which has certain reserves as defined in Section 803(b) of the 1954 Code. Whether or not this annuity company would qualify for the tax treatment of life insurance companies is questionable. However, it would appear that regular life insurance companies issuing a variable annuity contract would be taxed on the basis outlined above.

2. Tax on Annuity Payments. If these variable annuity contracts could qualify under the above outlined tax treatments, there would be substantial tax advantages in purchasing common

How Variable Annuity Works

SPONSORS OF THE BILL give the following example as to the manner in which the variable annuity will operate:

Adam Barr buys a variable retirement annuity certificate. He agrees to pay $50 a month until he is ready to retire. Each month when his $50 reaches the company, he is credited with a certain number of "accumulation units." The number of units purchased is determined in the same manner as the number of shares in an investment trust, except that under a variable annuity the money is applied on the last day of the month and the fund is valued on that day to simplify operations.

If he dies before he retires, the value of his units will go to his beneficiary, Mrs. Barr. They will be payable either in a lump sum, in installments, or as an annuity. If he has not already selected the type of settlement she will receive, Mrs. Barr herself may make a selection.

If he withdraws from the company before retirement, he may choose to receive the value of his accumulation units either in a lump sum or as a variable annuity. If he merely suspends payments, the certificate goes on the paid-up basis.

When he retires, which he may do at any time, his accumulation units will be converted to "annuity units." This will be done by the same mathematical process a life insurance company uses to convert a given number of dollars into an annuity payable in a fixed number of dollars. As in a life insurance company he can select among the different types of annuities; namely, a straight life annuity, an annuity payable for ten or twenty years certain and life, or a joint and last survivor annuity.

The annuity will be stated on a specified number of annuity units, based on the assumptions then made as to morality, yield, and expense, and will not vary once it is determined. But the amount paid out as an annuity will vary from year to year, depending on the value of the annuity unit each year. The value of an annuity unit will depend on dividends received, the changes in the market value of the assets, and to a small extent on the death rate of annuitants and the experience of the company in meeting expenses.

stocks through a variable annuity rather than individually or through some other medium.

First, the dividend income from the common stocks in which the purchaser of a variable annuity has an ownership interest would be accumulated and reinvested at a *maximum* annual tax rate of $6^1/_2$% as compared to a minimum federal income tax rate of 22% (and ranging up to over 90%) to which dividend income from common stocks owned in any other form is subjected.

Second, when a person starts receiving his annuity payments, which are payable for life, he takes as an annual deduction the total amount he paid for his annuity, divided by his life expectancy. For example, if over a period of years he made payments totaling $50,000 and his life expectancy was 20 years from the time he started receiving the annuity payments, then each subsequent year he could deduct $2,500 from his annuity payments and pay an income tax on the difference between $2,500 and what he received.

Additionally, during the period in which annuity payments would normally be received, the annuitant would be in a lower tax bracket than during his earning years and, if over 65, he would have a higher personal exemption. Thus the deferred tax on the accumulated income would be substantially lower (if not entirely avoided) than would have been the case if he had invested in common stocks through some other medium and paid taxes on his dividend income as it was received by him.

Further legislation sought

It should also be pointed out that the insurance companies have announced their intention of pressing for tax legislation next year which would have the effect of making the amount of annuity premium payments by the individual to the insurance company deductible from his taxable income. This would put annuity premium payments in the same category as charitable contributions, making that portion of an individual's annual income which is channeled into these premium payments *exempt from income tax.* Obviously, if this were to come about, there would be very little reason for anyone to purchase common stocks except through an annuity. ☆

A "grandfather trust" possibility under 1954 Code

LAST MONTH we had a sad lament for the "grandfather trust" (JTAX, Jan. 55, p. 23), which we feared would be less useful under the 1954 Code. But now comes Edward L. Allison, CLU, insurance man in Tulsa, who suggests insurance as a means to the same end. He puts the proposition, briefly, this way:

Now the $3,000 annual federal exclusion is available where gifts are made in trust for children under 21, provided the following tests are met:

1. The income and property may be expended by or for the child—any income not used must be added to the principal, and

2. The principal plus any income that accumulates must be payable outright to the child when he attains age 21, and

3. If a child dies while still in his minority, the fund must pass either to his estate or as he may appoint under a general power of appointment. Generally speaking, we would think that this condition would be met, so far as a life insurance policy is concerned, if the child's estate is named as a beneficiary and also as the contingent owner (assuming the policy is on another life).

If such gifts are to be placed in trust, then this new provision, like all the gift tax provisions, is effective after January 1, 1955. We are happy about this change because it clears the air as to the use of life insurance policies in grandfather to grandchild gift programs. It seems to us that the grandfather who wants to make gifts to his grandchildren can do no better than purchase policies on his son or daughter, pass title to the child immediately after the policy is issued, then pay annual premiums as gifts to the child and possibly provide in his will or testamentary trust that premiums be continued after his death until policy is paid up, or possibly provide for automatic paid-up insurance in event of his death. This is the ideal gift medium because it throws a forward pass to the third generation. The policy substantially appreciates in value at the death of the insured, the proceeds are not taxable in the grandfather's estate nor in the estate of the son or daughter. There is no income tax on the appreciation which takes place at death. Usually we suggest the use of 10-Payment Life policies for this purpose because the grandfather is usually a middle aged man and not anxious to get under long range commitments. If the policy is frozen at the grandfather's death, it will automatically pay up after premiums have been paid for two years or more, for an amount greater than the total premiums. ☆

New estate & gift decisions this month

Valuation of real estate, farm and security corporation; one gift or three? Taxpayer transferred 600 shares (74% of 820 outstanding, all owned by him) in trust for his three sons. Noting that the value per share of a 600 share block would be quite different from the per share value of a 200-share block and that there was little precedent on the issue, the court concluded that each of the three sons certainly received a gift and there were therefore three gifts of 200 shares to be valued.

The corporation owned real estate, operated a large farm, carried on forestry operations, held a large art collection it was liquidating and had a large portfolio of securities. The value of all these assets was stipulated except stock of Peter Paul, Inc., traded over-the-counter. After reviewing in considerable detail the evidence brought out by expert testimony of the breadth and depth of the market for this stock and the problems of liquidating a block, the Court valued the shares at $40 though bid was 44–45 and asked 46–$46^1/_2$. Including the stipulated value of other assets this made the per share asset value of the gift $3,118. The Court reviewed the education and experience of the expert witnesses for both sides and their methods of valuation—including the price that would be paid by some one purchasing for investment, for speculation, for merger, for liquidation. Much weight was put on the discount at which closed-end investment trusts sell and on the tax problems of a purchaser. The Court concluded a 600-share block would carry a 50% discount from asset value (or $1,559 per share) and a 200-share block would be worth $1,057 per share. The taxpayer had

originally valued the share at $1,000, the Commissioner at $3,228. *Whittemore* v. *Fitzpatrick,* DC Conn., 10/26/54.

Widows income after husband's death improper evidence of possibility of invasion. The estate had been allowed, after jury trial below, refund of estate tax paid on Commissioner's determination that the authority given the trustee to invade corpus for the widow's benefit was so wide that it was impossible to ascertain how much of the remainder would eventually go to charity and therefore the size of a charitable deduction for estate tax. The Circuit Court agrees with the District Court that as a matter of law the standard set in the will was definite; it was proper to submit to the jury the question of the extent to which invasion would be made. One dissent here on the ground that invasion could be permitted for personal use beyond the standard at date of death.

However, the case was sent back for retrial because of evidence admitted on the widow's income and expenses and the estate investments for six years following death. This was irrelevant to the issue of conditions at date of death. *Lincoln Rochester Trust Co.* (*Haroun Estate*) v. *McGowan,* CA-2 11/15/54.

Series G bonds in estate valued at par despite lesser redemption value during life. The Tax Court valued Series G Bonds held by the decedent at par. These bonds were not transferable and could be redeemed during life only at a discount. They were redeemable at par within six months of the death of the owner. The Circuit Court holds that the finding of the Tax Court is not clearly erroneous and must be sustained. The Tax Court moreover did not employ improper criteria—the market value (redemption value) as of the date of death is not the sole test of value. *Cullins* (*Gowdy Estate*) v. *Comm.,* CA-1 11/9/54.

Securities held "in trust for sons" not part of mother's estate. The Commissioner included in decedent's estate securities and savings banks accounts in her name as trustees for her sons. She had filed no gift tax returns upon purchasing the stock and no fiduciary income tax returns. However, the Court was convinced that her intent had been to give the property to her sons to equalize the daughters' larger inheritance from their father, and this form was adopted because they were minors. The assets were not includable in the estate. *Estate of Lily Koster,* TCM 1954-191.

Trustee mingled funds and left all property to beneficiaries; corpus not subject to tax. [Acquiescence.] The decedent had $30,000 property from her mother as trustee for her children. The property was never separated, but decedent acknowledged the trust. The decedent's will, with a penalty clause if it was contested, left all her property equally to her two children, the beneficiaries of the trust, and they took as residuary legatees. Pointing out the penalty if they had insisted on pressing the claims as beneficiaries, the Court allows deduction of $30,000 as a valid claim against the estate. ***Annie Feder Estate,*** 22 TC 30., *Acq. IRB* 1954-47,5.

Date of gift of stock is date of delivery of endorsed certificate to donee. If the donor delivers a properly endorsed stock certificate to the donee (or the donee's agent), the date of delivery is the date of gift. The fact that transfer on the books of the corporation occurs later is irrelevant. *Rev. Rul.* 54-554.

Gift incomplete when donor can revest title in himself. In a brief ruling not giving the facts, the Service states that a gift is incomplete and no tax attaches if upon the happening of a condition under his control the grantor of a trust can revest the property in himself. *Rev. Rul.* 54-537.

Gift can be complete if power to invade for grantor is determinable. The Service points out that in the *Gramm* case (17 TC 1063, *Acq.* CB 1952-1,2) the Tax Court held a gift in trust was incomplete because the expected income was small, the needs of the donor great and the possibility was that the trustee would invade corpus for the donor. In cases where the standard of living of the donor and therefore the possibility of invasion "for the support of the donor" can be valued like an annuity, this will be done and gift tax assessed on the remainder not liable to be used for the donor. *Rev. Rul.* 54-538.

IRS will treat related insurance and annuity contracts as life income and remainder of a fund. The IRS announced that it will not follow *Harrison* v. *Bohnen* (199 F.2d 492, *aff'd* 345 U.S. 946 by an evenly divided court) which held that the taxable estate did not include a life insurance policy, purchased simultaneously with an annuity policy, and given to the decedent's children. It will follow *Burr* (156 F.2d 871, *cert. denied,* 329 U.S. 785) and *Conway* (193 F.2d 965) which said that the two contracts must be treated as one and that by transferring the insurance policy, the decedent in effect retained a life interest in a fund with the company. The proceeds were therefore taxable as a transfer in which he retained an interest. *Rev. Rul.* 54-552.

Value of farm fixed. In an extremely brief opinion, the Court states merely that based on the testimony of four expert witnesses, it values a farm at $63,000. The Commissioner valued it

Control of Trusts: Taxable

Grantor of long-term trust taxed; he maintained control. Taxpayer transferred stock to trust for the benefit of his children. He continued, however, to exercise control over the trust funds, mingling the dividends on the stock with his own money, voting the stock without proxy from the trustee (his wife), and investing trust funds as he saw fit. The District Court found no diminution in taxpayer's control over the corpus or income of the trust and held the income diverted to the trust was taxable to the taxpayer as settlor. The Circuit Court affirmed the judgment dismissing the taxpayer's claim for a tax refund. *Moskin* v. *Johnson,* CA-2, 11/26/54.

Grantor's reserved right to increase trustees' powers make trust part of his estate. Upon creation of a trust, the grantor provided that he might give the trustees additional powers. The Court finds no limitation of possible powers to be given and concludes that, since the grantor might give the trustees the power to change the distributive shares of beneficiaries, the gift was incomplete, and the trust properly part of the grantor's estate. *Fidelity Union Trust Co.* (*Will of Hurley*) v. *U.S.,* CtCls. 11/30/54.

at $93,530, and the taxpayer at $50,000. *Estate of Gus Engstrom,* TCM 1954-197.

No marital deduction for gift to life-insurance trust for wife. The taxpayer claimed a marital deduction for premiums he paid on insurance on his life held by a trust in which his wife had the right to income and power of appointment over the corpus. Such premium payments were taxable gifts. The court upheld the Commissioner's action in disallowing the deduction as contrary to the regulations (upheld as valid) permitting the marital deduction only if the trust corpus is income-producing. The wife here has no right to force the trustee to convert the policies to income-producing investments. *Estate of C. G. Smith,* 23 TC No. 44.

No marital deduction where widow can take half of single insurance fund. The IRS holds that no marital deduction is allowed if the proceeds of life insurance are held by the company in a single fund, on which interest is paid to the surviving spouse, even though the spouse has the right to withdraw one half the proceeds in one withdrawal at a time. The IRS points out that the Code requirements of a power of appointment over property held in trust are similar to powers over insurance proceeds. In trusts, the law and regulations (under the 1939 Code) require that the spouse have power over all the corpus of a single trust. Similarly, the Regulations require that the spouse have a power over insurance proceeds held in a single fund. Since the spouse, in this case, has power over only one half of the proceeds in a single fund, no deduction is allowable. *Rev. Rul.* 54-553. [54 Code changes this. Ed.]

Estate deduction allowed for payment to ex-wife as founded on decree, not agreement. Decedent and his wife agreed in 1942 that she would receive 1/3 of his estate if she were unmarried at his death. This agreement was incorporated in their subsequent divorce decree. Upon the husband's death the former wife received the agreed 1/3. The Commissioner contended that no deduction was allowable because the claim was founded on a "promise or agreement" supported only by a relinquishment of marital rights, not a consideration in money or moneys worth by statute. The estate contended the claim was founded on the divorce decree, not the agreement. The Second Circuit upheld the Tax Court in finding for the estate. It reviewed the *Harris* case (340 U.S. 106) and noted that the purpose of the disallowance of deduction of claims not based on money consideration was to prevent the transmutation of bequests into claims by agreements not bona fide. It saw no reason for a distinction between agreements incorporated in a divorce decree and those followed by, but not incorporated in, a decree. "The fact of divorce and the adoption by the decree of the financial terms agreed upon . . . should be taken . . . as satisfying the purpose of the statute." [The 1954 Code changes this rule. Ed.] *Watson Estate* v. *Comm'r.,* CA-2, 11/8/54.

ERRATUM: Last month (page 50) we described Robert Lloyd as a "CPA and attorney associated with Peat Marwick Mitchell & Co." He is in fact a CPA and a partner in that firm. The error is the editor's, and we apologize to Mr. Lloyd.

TAX COURT DIGEST

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Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Pennsylvania tax man finds pre-trial conferences of little value

IN OCTOBER we suggested that if a careful and fair review were available in the office of the Assistant Regional Commissioner–Intelligence, as seemed to be indicated by the procedure set up at San Francisco, counsel for taxpayers involved in a criminal tax investigation might well consider availing himself of this review (JTAX, Oct. '54, p. 38). We invited comments from readers.

We received an interesting letter from Kalman A. Goldring, a Pittsburgh tax man, who says:

"While my own experience with such conferences is by no means so great as yours, I must say that I have not found the conferences very useful.

"I have reached the point where I seriously question the benefit to be obtained in conference on a proposed criminal fraud case below the level of enforcement counsel. It has been my experience, in dealing with both the head of the Intelligence Division in the District Director's office and the Group Chief in that office, to be met with a statement 'We propose to recommend criminal prosecution, we cannot give you the figures nor can we tell you the theory upon which we base our proposal; but we do give you an opportunity at this time to tell us any reason which you might have why we should not recommend criminal prosecution or submit any information on behalf of the taxpayer which you think we should consider.'

"I have not felt that this attitude is helpful at a conference. To my mind a conference is an open discussion in which there is some disclosure of what the position of the parties is. If the theory and figures upon which the prosecution are based is not disclosed, how can there be a presentation by counsel for the taxpayer of information to show that the theory or the figures are erroneous? Again, if the figures are not disclosed, how can a representative of the taxpayer risk disclosing figures he may have? He might thus put new weapons into the hands of the government.

"Some time ago, a Special Agent in the early stages of his investigation told me that the income of the taxpayer would be computed by him on a net worth basis. We proceeded to make an exhaustive net worth analysis and completed a net worth statement which the Special Agent admitted was without demonstratable error. Subsequently at a conference with the head of the Intelligence Division the head said 'We have decided to use an approach other than net worth but we cannot tell you what our approach is or what the resultant figures are. We, however, give you the opportunity to make any further submission or statement which you desire on behalf of the taxpayer before we forward the case to the office of the Regional Commissioner.' Similarly, in another case, the statement was made that the agents found sources of unreported income but refused to discuss even the category of the items.

"I might point out that the only time we have requested a conference in the Intelligence Unit of the Regional Commissioner's office in Philadelphia, that request was completely ignored.

"Other practitioners in Buffalo, Pittsburgh and Philadelphia have had the same experience. As a matter of fact, as I was reading your article, another practitioner came in to ask whether I knew of any way to get any more information from Enforcement Counsel than the bare net civil figures; everything which he had been able to find could not begin to justify anything approaching the income and tax figures supplied by Enforcement Counsel. In that case Enforcement Counsel did not even give a statement of the general method used by them or the nature of the purportedly understated or unreported income.

"On the basis of our experiences, we wonder whether a conference is worth while in any stage of a recommended criminal case. I was surprised to note the difference between your experience and mine; and also that of practitioners of my acquaintance."

Your editor wrote to Mr. Goldring as follows: ". . . I did not mean to imply in my article that a practitioner would be able to smoke out any important information from the Intelligence Division if he availed himself of conferences and reviews at levels above that of the Special Agent. I quite agree with you that if this is the purpose of a conference it will usually prove fruitless. I intended only to point out that my own experience in the San Francisco office of the Assistant Regional Commissioner–Intelligence Division indicated that a courteous and fair conference was arranged.

"From a practical point of view, it may be quite as fruitless as you have supposed, since the case moved on with a prosecution recommendation from the Intelligence Division to the Regional Counsel, where I have had a subsequent conference and where the matter is still pending."

And Mr. Goldring's reply

"I just am unable to see how a conference can be of real benefit to *both* parties unless the government is willing to supply the information which would normally be contained in a proper indictment or bill of particulars. Of course, I did not intend to suggest that a conference be used to ferret out information which should properly be withheld by the government or the evidence against the taxpayer.

"I have in mind a case where the government's so-called 'civil figures' show a half-million of unreported gross receipts for a business. A complete detailed audit including a complete verification of purchases convinces us that the unreported gross receipts, if any, is de minimus. If a conference is to be considered a presentation by the taxpayer, we can submit our audit for attack. I think it only fair that if we submit our figures for their attack we be given enough information of the details behind their figures to have an equal opportunity to attack their figures.

"When we consider the serious effect that an indictment can have on the good will of a business, the saving of the opportunity for attack until the presentation before the trial jury penalizes the taxpayer even though he is acquitted.

"My question is what you consider a 'fair' conference. Courtesy I have always received. I receive that also from audiences when I lecture. But I do not consider an opportunity to give a lecture on a case to a courteously receptive, noncommenting audience a conference, fair or otherwise." ☆

New decisions

Negligence but not fraud found; businessman kept few records, filed no returns. The taxpayer did not appear at the hearing; however the Court found the Commissioner had not sustained the burden of proof of fraud. Taxpayer had two years of college and other accounting courses, and he had been a bank loan officer. From 1942 to 1946 he filed no returns, though he engaged in several different businesses in Alabama. He had few records and was uncooperative. The Court holds this was not more than negligence. *Charles W. Williams*, TCM 1954-199.

Fails to appear; court upholds commissioner's finding of fraud. Where taxpayer, who had the burden of proof, failed to appear, deficiencies determined by the Commissioner stood, and the court found as a fact that 1945–1947 deficiencies were fraudulently intended to evade tax; the opinion did not reveal the facts or the rationale. *Paul J. Harrington*, TCM 1954-204.

Commingled net worth of spouses allocated to each for deficiency on separate return. Husband and wife were physicians in Philadelphia. They kept no records; the Commissioner computed the increase in their joint net worth. For some of the years involved they had filed joint returns; for others separate. The Court allocated to each spouse the net worth increase from its estimate of the time each devoted to practice. Fraud penalties sustained. *Henry B. Mikelberg*, 23 TC No. 41.

Net worth determination upheld though source of income unknown. Taxpayer correctly returned his income from known sources in 1945–1947. As his net worth (computed on the basis of visible assets) increased by amounts greatly in excess of income reported the court approved the Commissioner's assessment of a tax on the unreported income plus a 5% penalty for negligent or intentional disregard of rules and regulations. *Jacobs* v. *U.S.*, Ct. Cl., 11/30/54.

Net worth method is proper where there were no inventory records; fraud penalties sustained. The Commissioner determined tax deficiencies by using the net worth method even though there were some journals available. However, the inventory records were either missing or, the Court held, untrustworthy. In this situation, use of net worth was proper. Net worth is not a method of accounting; it is merely a marshalling of evidence to show understatement of income. Deficiencies were collectible from the taxpayer's children as transferees. *George L. Cury Estate*, 23 TC No. 40.

Tax court upheld in finding fraud in all eight years' understatement despite mental illness in one. The Fourth Circuit states it would be unjustified in setting aside the Tax Court finding that there was fraud in a gross understatement of income, even though the taxpayer was mentally ill, when it found fraud in six preceding and one following year in which there was no claim of illness. *Staudt* v. *Comm'r.*, CA-4, 11/8/54.

Fraud in failure to report over-ceiling cash sales. *[Acquiescence.]* Taxpayer's whiskey business was operated in daughter's name but is held taxable to father who actually ran it. No capital was used. Taxpayer conceded that he received cash payments in excess of ceiling prices on whiskey sold but claimed he paid all of it for supplies. The Tax Court disbelieved the suppliers' statements that he paid them only ceiling prices and, exercising practical judgment, allowed amounts equal to about $^2/_3$ of over-ceiling receipts as over-ceiling costs. Fraud penalties for failure to report over-ceiling sales sustained. *David J. Pleason*, 22 TC 361, *Acq. IRB* 1954-47, 5.

Fraud in "cash sales" not reported; taxpayer had been convicted of evasion. The Commissioner, by reference to taxpayer's customers and to check cashing companies, showed that taxpayer made substantial sales he did not pass through his bank, enter on his books or report on his tax return. Taxpayer did not appear, but the court finds the Commissioner sustained his burden of proving fraud. *Saul Schlenoff*, TCM 1954-200.

Treasurer given new trial; company

Reliance on Professional Tax Advice

Voluntary disclosure letter, based on accountant's error, no basis for fraud penalty. Taxpayer had a junior accountant install a bookkeeping system for his small-town department store. After a cursory inspection of the accounts, the accountant fearing that the taxpayer might have understated his income in prior years prepared a memorandum listing every possible means that the taxpayer could have used for diverting income and entered an amount for each item which he considered in excess of the remotest figure an audit might show. A voluntary disclosure was then made and the Commissioner assessed deficiencies and fraud penalties, the latter based on the taxpayer's admissions against interest in the voluntary disclosure. The Tax Court disallowed the fraud penalty. Subsequent investigations showed that there was no basis in fact for the statements in the accountant's memorandum. The accountant, young and inexperienced, admittedly erred in jumping to a hasty conclusion at a premature stage of his initial audit. *Newton V. Prince*, TCM 1954-214.

Reliance on counsel's advice is for jury consideration. In a jury trial for tax evasion there was testimony to the effect that defendant's failure to report income from segregated funds was based on his reliance on advice of counsel. The court held it was error for the trial judge to refuse to instruct the jury as to the relation of such reliance to the issue of wilfulness. The defense of reliance was not formally pleaded. *Phillips, U.S. v.*, CA-7, 12/2/54.

lawyer defended him and stockholder-owner despite conflict of interest. Craig was treasurer of Ohio Tool Company, of which Butzman was chief owner and officer. Butzman was convicted of fraudulently executing an application for a tentative Adjustment of Amortization Deduction, and Craig of aiding. On appeal, Craig argued that his trial was unjust because he was defended by the company lawyer who also defended Butzman. The Court finds that Craig did not, deliberately and intentionally, waive his right to counsel, and that because of the conflict of interest between him and Butzman, Butzman's counsel did not effectively represent him. New trial ordered. *Craig* v. *U.S.*, CA-6, 12/6/54.

5-year Statute of Limitations inapplicable; no 25% understatement. Where taxpayer failed to show that increase in net worth during 1944–1947 was not due to unreported income, the Commissioner's determination and 5% negligence penalty was allowed for each year but 1944. Assessment was precluded for that year by the 3-year Statute of Limitations; the 5-year Statute was inapplicable as it was not shown that the taxpayer had understated his income by more than 25%. *Jacobs* v. *U.S.*, Ct. Cls., 11/30/54.

5-year Statute of Limitations applied; 25% understatement of income. The 3-year Statute of Limitations was not applicable to the sole proprietor of a small department store. Since his gross income was understated by more than 25%, the 5-year Statute applies. *Newton V. Prince*, TCM 1954-214.

Junk dealer's books false; fraud penalties upheld. Commissioner asserted deficiencies of about $48,000 and fraud penalties of about $24,000 for the years 1942–1950. Taxpayer made purchases and sales for cash, but the Commissioner properly disregarded his books. The bookkeeper credited a special cash account with all cash receipts he knew of and charged to it all checks drawn to cash. The balance he treated as cash purchases. The commissioner reconstructed income on a net worth basis, including as living expense all checks cashed in local gambling houses, rejecting the taxpayer's testimony that many such checks were cashed as favors or to obtain cash for business uses. *Ben Friedman*, TCM 1954-198.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

A simple method for calculating interdependent taxes and related payments

by NATHAN E. JORDAN, CPA

IN TWELVE* of the forty-eight states, federal income taxes are allowed as a deduction from gross income by corporations on the accrual basis. Inasmuch as the state tax is similarly deductible on their federal returns, there arises a problem of computing these interdependent taxes. When this problem is further complicated by the introduction of an executive bonus based upon net income after tax(es) and/or after the bonus itself, getting the solution becomes a burdensome task.

The average practitioner when faced with these problems, resorts to "trial and error" and eventually arrives at a solution. However, there has been evolved a simple arithmetical solution to this type of problem. It consists of estimating one of the *two* unknowns, computing the second and in *four* repetitive steps arriving at an exact solution. In cases involving *three* unknowns —estimating two, computing the third, and in *five* repetitive steps, arriving at an exact solution.

In the illustrations presented below, the algebraic equations will be formulated (but not solved) and the simple arithmetical solutions detailed. The terms to be used are as follows:

P = Net Profit before taxes and/or bonuses
F = Federal tax (52%–$5500)
S = State tax (4%)
B = Bonus

Illustration A

To determine the interdependent federal and state taxes on a net profit (P) of $50,000. The algebraic equations are:

F = 52% ($50,000 −S)−$5500
S = 4% ($50,000 −F)

* Alabama, Colorado, Idaho, Iowa, Kansas, Kentucky, Louisiana, Missouri, New Mexico, North Dakota, Oklahoma, and Oregon.

ILLUSTRATION A: FEDERAL AND STATE

FEDERAL TAX COMPUTATION	*Step I*	*Step II*	*Step III*	*Step IV*
Net Profit	50,000.00	50,000.00	50,000.00	50,000.00
Less: Estimated state tax	2,000.00	(A) 1,221.60	(B) 1,205.41	(C) 1,205.07
Subject to federal tax	48,000.00	48,778.40	48,794.59	48,794.93
Federal Tax	19,460.00	19,864.77	19,873.19	19,873.36
STATE TAX COMPUTATION				
Net Profit	50,000.00	50,000.00	50,000.00	50,000.00
Less: Federal tax (above)	19,460.00	19,864.77	19,873.19	19,873.36
Subject to state tax	30,540.00	30,135.23	30,126.81	30,126.64
State Tax	A) 1,221.60	(B) 1,205.41	(C) 1,205.07	1,205.07

The letters A, B, ond C denote successive substitutions.

Note: When the final figures in Steps III and IV agree, then the figures in Step IV are the exact solution.

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In the arithmetical solution that follows, we estimate the state tax in the first step only and then compute all the remaining figures. Work straight down each column to the bottom. Then substitute the final figure for the estimated figure in the following step. In each case substitute the calculated figure for the estimated figure in successive steps.

Illustrations B

To determine the interdependent federal and state taxes and the executive bonus. The net profit (P) is $100,000 and the bonus is equal to 10% of the net profit after the state tax *and* after the bonus. The algebraic equations are:

$$F = 52\% \ (100{,}000 - S - B) - \$5500$$
$$S = 4\% \ (\$100{,}000 - B - F)$$
$$B = 10\% \ (\$100{,}000 - S - B)$$

In the arithmetical solution that follows, we estimate the state tax and the bonus in the first step *only* and then compute all the remaining figures.

Note that the answer evolves as successive substitutions move closer to the final correct figure; there are four such substitutions in this example. ☆

New procedural decisions this month

Wife's year held open by husband's suit that income should be taxed to her. On redetermination of taxpayer-wife's separate income tax return the IRS eliminated dividend income from her return and included it on husband's, resulting in a refund to one and a deficiency assessment against the other. On husband's recovery of the deficiency assessment by court determination in May 1952, the Commissioner mailed to the wife notice of deficiency based on reinstatement of dividend income and assessed the deficiency against her in September 1953. The assessment was held to be within the one year limitation after "determination" of the case of a related taxpayer; and under Sec. 3801 the Commissioner could assess her. *Bishop* v. *Reichel*, DC N.Y., 11/15/54.

Gross amount of rents must be reported by real estate agents. A real estate agent must report on Information Return, Form 1099, the gross amount of rents collected for property owner (without deduction of commissions, fees or expenses retained) if the amount totals $600 or more. *Rev. Rul.* 54-571.

Contested Excess Profits tax not deductible to accrual-basis taxpayer in year remitted. (***Cert. granted.***) In 1947 the taxpayer paid excess profits taxes for prior years. The Collector carried this payment in a suspense account until settlement was effected between the taxpayer and the government in 1948. The Second Circuit held that the taxes were not accrued while still being contested and thus they accrued in 1948 and could not increase a 1947 net operating loss. *Lewyt Corp.* v. *Comm'r.*, CA-2, 7/14/54; *cert. grtd.*, 12/6/54.

Date of court order for deficiency dividend. If a personal holding company declares a "deficiency" dividend within a limited time after establishment of a personal holding company tax, the dividend can be credited in apart against the deficiency. For this purpose, the date of entry of a Tax Court order is to be considered the date it became final. *Rev. Rul.* 54-536.

Illustration B: Federal, State and Bonus

	Step I	*Step II*	*Step III*	*Step IV*	*Step V*
Federal Tax Computation					
Net Profit	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Estimated state tax	2,000.00	(A) 2,288.80	(C) 2,017.28	(E) 2,010.87	(G) 2,010.80
Estimated bonus	9,000.00	(B) 8,871.12	(D) 8,911.16	(F) 8,907.80	(H) 8,908.14
Total deductions	11,000.00	11,159.92	10,928.44	10,918.67	10,918.94
Subject to federal tax	89,000.00	88,840.08	89,071.56	89,081.33	89,081.06
Federal Tax	40,780.00	40,696.84	40,817.21	40,822.29	40,822.15
State Tax Computation					
Net Profit	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Federal tax (above)	40,780.00	40,696.84	40,817.21	40,822.20	40,822.15
Bonus (above)	2,000.00	8,871.12	8,911.16	8,907.80	8,908.14
Total deductions	42,780.00	49,567.96	49,728.37	49,730.09	49,730.29
Subject to state tax	57,220.00	50,432.04	50,271.63	50,269.91	50,269.71
State Tax	(A) 2,288.80	(C) 2,017.28	(E) 2,010.87	(G) 2,010.80	2,010.79
Bonus Computation					
Net Profit	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
State tax (above)	2,288.80	2,017.28	2,010.87	2,010.80	2,010.79
Bonus (above)	9,000.00	8,871.12	8,911.16	8,907.80	8,908.14
Total deductions	11,288.80	10,888.40	10,922.03	10,918.60	10,918.93
Subject to bonus	88,711.20	89,111.60	89,077.97	89,081.40	89,081.07
Bonus	(B) 8,871.12	(D) 8,911.16	(F) 8,907.80	(H) 8,908.14	8,908.11

The letters A, B, C, D, E, F, G and H, denote successive substitutions.
Note: A difference in pennies may result from rounding off decimals; an additional step will eliminate it.

Priority of Government set-off over lien. In two cases where the government had a set-off against a refund of taxes, it was held superior to liens of an attorney and an accountant. Attorney prosecuted a claim for refund of excess profits taxes (which refund was made) and a later claim based on an inaccurate computation of interest (for which a check was mailed but not collected). The Commissioner later determined that the client owed the government withholding and federal unemployment taxes and applied the amount of the uncollected checks as an offset against the indebtedness. The court dismissed the attorneys' claim for fees holding it subject to the government's right of set-off. *Bronzan and Holman* v. *U.S.*, DC NY, 11/16/54.

Accountants were retained to prosecute a claim for tax refund. A government set-off against the refund was held superior to the rights of the accountants as assignees or equitable lienors. *Kleiger and Rosenbaum* v. *McMahon*, DC NY, 11/16/54.

Treasury will continue to accept incomplete Forms 720. The Treasury has been accepting incomplete reports on Form 720, quarterly reports on manufacturers' excise, retailers' excise, services and facilities. Such returns will continue to be acceptable provided items 1 through 6 are completed. No change in this policy is contemplated until study can be given to the problem, after work required on the new Code is completed by the IRS. *Rev. Rul.* 54-539.

Facts here found same as in earlier case holding race track taxable on wager fee for capital improvements. Taxpayer, operator of the Bowie track, contended that its case differed from *Maryland Club*, 210 F. 2d 367, *cert. denied* 347 U.S. 1014, which held the Club taxable on receipts from a fund collected by the Racing Commission from each track equal to 0.5% of amounts wagered. The Commissioner was authorized to pay back these sums to each track within three years in reimbursement of the cost of improvements. Taxpayer here urged that its facts differed, but the court finds the facts are the same, the taxpayer is simply trying to draw different conclusions. The years involved in both cases were 1948–1950. The court therefore does not consider the effect of 1951 amendments to the Maryland law. *Southern Maryland Agric. Assn.* v. *U.S.*, DC Md., 11/29/54.

Tax deferred by 722 claim is "standard" issue. [Non-Acquiescence.] Taxpayer deferred part of its excess profits tax upon filing its 722 claim for relief. The statutory notice of deficiency proposed only disallowance of the claim for relief and stated the deficiency as the excess profits tax reduced by the deferment. The Court holds that the deferment raises a standard issue not mentioned in the deficiency notice and therefore not properly before the Court. *Pittsburgh & Weirton Bus Co.*, 21 TC 888, *Nonacq. IRB* 1954-47, 5.

Motion for summary judgment denied where issue is testatator's intent. The Commissioner disallowed a charitable deduction because the will provided that the funds were to be used for, among others, "benevolent" institutions. The court pointed out that whether this direction would permit uses not sanctioned by the Code was a question of the decedent's intent which it would be improper to decide solely on affidavits. The evidence would naturally be largely in the hands of the executors and the Government should be given the right of cross-examination and the other safeguards of a formal trial. *Cochran* v. *U.S.*, DC Conn., 8/30/54.

Not necessary to prove Commissioner's assessment unjust. The Sixth Circuit remanded to the District Court for a new trial an estate tax case turning on contemplation of death. The judge had instructed the jury that before it could disregard the assessment they must be convinced the Commissioner had acted in an unwarranted and unjust manner. This was erroneous as the presumption of correctness disappears when evidence is offered to overcome it. The presumption is not evidence. While taxpayer's counsel did not object to this instruction there was error, objected to, in not permitting him to show that when the Commissioner made the assessment he did not have all the facts. There was further error in permitting a revenue agent to give the reason why he concluded the transfers were made in contemplation of death. *Kentucky Trust Co. (Schmidt Estate)* v. *Glenn*, CA-6 11/22/54.

Court believes wife did not intend joint return. The Commissioner attempted to collect from the taxpayer the deficiencies and penalties assessed against her husband, on the ground that the apparently separate return he filed was really joint, since it included income from real estate owned by them as tenants by the entirety. Under Maryland law, each was entitled to one half of the income of such property. Despite the fact that the wife was taxable on half the income, the Court found that she believed she had assigned it all to her husband and that she was not required to file a return. Hence, since she had no intention of filing a joint return, she is not liable for tax and penalty assessed against her husband. *Elsie S. Bour*, 23 TC No. 35.

Commissioner must prove, not merely allege, that waivers extended assessment date. In its petition to the Tax Court, taxpayers alleged that the assessments were barred by the Statute of Limitations. The Commissioner alleged that waivers were executed, to which taxpayer replied the waivers were untimely or obtained by duress. No waivers were put into evidence at the trial. The Tax Court found the assessments barred and refused to permit the Commissioner to reopen the record to submit the waivers. This the Fourth Circuit holds was in error, and reversed and remanded solely to allow evidence of waivers to be submitted. *Williams Estate* v. Commr., CA-4, 11/8/54.

Summary judgment is improper when taxpayer did not prove payment of deductions disallowed under erroneous theory. Taxpayer sued for refund of additional income tax paid when the Commissioner disallowed the over-ceiling portion of cost of goods sold. The District Court granted a motion for summary judgment for the taxpayer. This action, the Circuit Court holds, was improper—the Government, in its answer, had denied that the taxpayer made the excessive payments; therefore, taxpayer should be required to prove the payment. *Harris, U.S.* v., CA-5, 11/16/54.

Tax Court petition, mailed on 89th day received on 91st, is good. Tax Court denies the Commissioner's motion to dismiss on the ground the petition was not filed with the statutory 90-day period. Notice of deficiency was mailed June 18, 1954. Taxpayer's petition was filed, *i.e.*, received by the Tax Court

on September 17, the 91st day. However, it was postmarked September 15, and under the 1954 Code, the postmark date is deemed date of delivery. The petition is timely filed. *Phillips*, TC Docket 54748.

Applying Cohan rule, court allows costs for unreported sales; additional salaries. Taxpayer admitted they omitted substantial sales. However, they claimed that unreported costs should also be included in the recomputation of income. Applying the *Cohan* rule, and bearing heavily against the taxpayers, the court allows additional costs. It also allowed $25 a week additional salary for stockholder employees; taxpayer had claimed it had paid $130 a week more without reporting it. *Samuel Liebenson*, TCM 1954-202.

District Director can reduce extended filing time. The District Director has authority not only to grant extensions of time for filing income tax returns but also reduce extension where the return is filed prior to the close of the extended period. *Rev. Rul.* 54-568.

Property transfer to avoid tax payment set aside. The court found that the delinquent taxpayer had transferred real estate to a minor for purpose of defrauding the government. It decreed that the deed of transfer be set aside and that the property be sold for the benefit of the government if the back taxes were not paid within six months. *Hays, U.S.* v., DC W. Va., 11/19/54.

No transferee liability on insurance proceeds. Following a Second Circuit decision (*Rowen*, 215 F. 2d 641) the Seventh Circuit court holds that the government could not recover taxes owed by the deceased husband from life insurance proceeds paid to the wife. The proceeds were never part of the deceased's property notwithstanding his right to change the beneficiary. *New, U.S.* v., CA-7, 12/2/54.

Payment of refund does not bar deficiency. In what the Court characterized as a confusing *pro se* petition, taxpayer claimed that the Commissioner was precluded from assessing a deficiency ($153) because he had made the refund claimed on the return ($151.55). The Court said merely that the contrary is well established. *Jack B. Boysen*, TCM 1954-203.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Is there a loophole in the new law on collapsible corporations?

THE COMMISSIONER'S FAILURE in the past to make any real headway in overcoming that brainchild of the rich and clever taxpayer, the collapsible corporation, caused him to seek reinforcements from Congress. The purpose of the collapsible corporation, of course, is to convert ordinary income into capital gain. And it works. At least it has worked, for the courts have generally upheld the taxpayer.

Congress apparently intended to give the Commissioner the strength he needed to banish the collapsible corporation with Section 117(m) of the 1939 Code; this has been substantially re-enacted as Section 341 of the 1954 Code.

How the idea developed

The plan was first used by moving picture producers. A corporation was formed for the sole purpose of producing one moving picture. After the picture had been produced, but before any rental income had been realized, the corporation was dissolved. The stockholders reported as the fair market value of the picture the amount of the expected rentals. They deducted their investment in the stock and reported the difference as capital gain. The fair market value was then amortized against the rental income. If they were accurate in estimating the total rent to be received, the entire amount thereof was taxed at capital gains rates, albeit somewhat sooner than realized in cash.

This device was later employed by construction companies. A corporation was formed to construct a building. After construction was completed, the corporation was dissolved and the building reported at its expected resale value. Had the building remained in the corporation, the gain would have been taxed to it as ordinary income and, upon dissolution, the shareholders would have paid a capital gains tax on the gain. In some cases this device was used in a large construction project involving numerous houses.

Change in the law

In 1950, Congress closed this loophole by enacting Section 117(m) of the 1939 Code. It provided that the gain on the dissolution of one of these collapsible corporations, or on the sale of its stock, would be taxed as ordinary income. In 1951, the Act was amended to include corporations used for converting income from inventories into capital gains.

The provisions of Section 117(m) of the 1939 Code have been re-enacted as Section 341 of the 1954 Code. The language in Section 341 follows that of Section 117(m) very closely. An addition has been made relating to unrealized receivables, and a presumption has been set up under certain circumstances, but basically the law remains the same.

Attempt to eliminate double tax

Under Section 337 of the new Code, if a corporation adopts a plan of complete liquidation and within 12 months thereafter sells all of its assets, no gain or loss will be recognized on such sales. A corporation which owns an apartment building or a group of houses can adopt such a plan, sell its property without corporate tax, and then distribute the proceeds to the shareholders. The shareholders will report as a capital gain the difference between the amount

received and the cost of their stock. If such a corporation sells its inventory to one person in one transaction, there will be no tax to the corporation on the profit therefrom. This section was enacted to prevent the double taxation rule applied in the case of *Commissioner* v. *Court Holding Co.*, 324 U.S. 451, as modified by *U.S.* v. *Cumberland Public Service Co.*, 338 U.S. 341. It is specifically provided in this section that it shall not be applicable to a collapsible corporation.

Let us assume that you have, under Section 337, liquidated a corporation which constructed an apartment building in 1954. The corporation sells the apartment building in 1955, after having adopted the plan of liquidation. It distributes the cash to its shareholders. The corporate return will show no gain on this transaction. Then an examining revenue agent takes the position that it was a collapsible corporation and that Section 337 is not applicable.

Three necessary elements

Under Section 341, the definition of a collapsible corporation requires that three elements be present. First, the corporation must have been formed or availed of principally for the manufacturing or production of property, or for the purchase of certain property, or for the holding of stock in a corporation so formed or availed of. Our corporation was formed to construct an apartment building, and therefore comes under this provision.

Under the second provision, the corporation must have been so formed or availed of with a view to the sale or exchange of stock by its shareholders, or a distribution to its shareholders, *before the realization* by the corporation of a substantial part of the taxable income derived from such property. Our corporation was availed of for a distribution to its shareholders, but did that distribution take place before the realization by the corporation of the income from the property? It would appear that the corporation realized the income from the property when it sold it. This would be particularly true if the apartment building had been constructed primarily for resale. It would seem that the corporation does not meet this test, because the distribution to its shareholders took place after the sale.

The third requirement is that it must have been formed or availed of for the realization by its shareholders of the gain. It is obvious that, in this case, the gain was realized by the shareholders.

We would not recommend that anyone dissolve a collapsible corporation for the purpose of testing whether this theory is correct. However, we do feel that if a collapsible corporation has been inadvertently dissolved under Section 337, it can well be argued that it was not, in fact, a collapsible corporation, because it was not dissolved until after the sale of the property and the realization of the gain by the corporation. ☆

Lease to controlled corporation should be short term

TRANSACTIONS BETWEEN a closely held corporation and its shareholders are always looked at twice by the Commissioner. Too often these transactions would not take place in the absence of the relationship. Thus, in *Ray's Clothes, Inc.*, 22 T.C. No. 166, a closely held corporation was operating on leased premises. Its stockholders bought the property and entered into a new lease at a higher rent. The purpose of the new lease was to enable the stockholders to obtain a higher mortgage at better terms than the old lease would have permitted. The Commissioner disallowed all of the rent over $10,000. The Tax Court sustained the disallowance of the additional rent during the term of the original lease but allowed the new rental thereafter. The court pointed out that in an arm's-length transaction, a lessee would not voluntarily have increased its rent.

It is quite common for the stockholders to own the property the corporation is using and rent the property to the corporation. Care should be taken to avoid long-term leases of this kind, lest the court apply the rule of this case. Thus, if a corporation has leased its property from its shareholders, or from another corporation controlled by its shareholders, for a five-year period at a rental of $500 a month, and it is decided to increase the rent to $1,000 a month, the Commissioner could well disallow the increase during the term of the existing lease. The rental might be in every respect fair, but an unrelated lessee would not normally consent to an increase of rent when it had a valid existing lease. For this reason, leases between corporations and their shareholders should normally not be made for a period in excess of one year. ☆

Stockholder protests issuance of rights resulting in tax; corporation explains

ONE OF OUR LARGE CORPORATIONS recently issued rights to buy a new class of preferred stock to its common stockholders. According to a ruling obtained by the corporation, the stockholders received ordinary income, taxable in full, upon sale or exercise of his rights. One stockholder wrote the company protesting that the transaction could have been arranged so as to require only a capital gain tax.

The ruling which controls

Here is what the Commissioner's ruling on this particular case says (in part):

1. IF THE RIGHTS WERE EXERCISED—Stockholders who exercised the rights received by them realized income taxable as a dividend to the extent provided in section 115(a) of the Internal Revenue Code of 1939. The amount of the dividend income is measured by the difference, or spread, between the fair market value of the preferred stock and the subscription price on the date the rights were exercised.

The basis of the new preferred stock, Series C, in the hands of stockholders who subscribed for such stock by exercise of stock rights received on the distribution is the subscription price paid therefor plus the amount reportable as dividend income. The holding period of the Series C preferred stock acquired by exercise of stock rights commenced with the date upon which the rights were exercised.

2. IF THE RIGHTS WERE SOLD—Stockholders who sold the rights received by them realized ordinary income, as provided in section 22(a) of the Code, to the extent of the entire amount of the sale price.

3. IF THE RIGHTS WERE ALLOWED TO EXPIRE—Since the stockholders were not in receipt of taxable income at the time the rights were issued, no deductible loss was sustained if any of the rights were allowed to expire without exercise or sale.

4. IF THE RIGHTS WERE DONATED TO CHARITABLE, ETC. ORGANIZATIONS—With respect to those cases where the holders of the company's common stock donated the rights to organizations of the type referred to in section 170 of the Internal Revenue Code of 1954, such donors will not realize taxable income by virtue of such donations, since the donations are not a sale or conversion of the rights. (See section 39.41-2 (a) of Regulations 118 and Treasury Decision 6091, I.R.B. 1954-35,13.) It is further held that the donors will be allowed deductions, under section 170 of the Code of 1954, for the fair market value of the rights contributed, measured by the average of the high and low quotations for the rights on the New York Stock Exchange on the date the rights are donated, subject to the limitations set forth therein.

5. BASIS OF COMMON STOCK UNCHANGED—The cost or other basis to the stockholders of their original common stock, with respect to which the rights were issued, will remain the same regardless of whether the rights received were exercised, sold, allowed to expire without exercise or sale, or given away.

The stockholder complains

Some stockholder unhappiness was caused by this state of affairs, and the company found it necessary to explain its position. The reply is interesting, as an example of how taxation and corporate necessities have to be combined. The company wrote substantially as follows.

You request an explanation as to why the rights issued by the Company gave rise to taxable income upon the exercise or sale thereof, when in other cases the recipient is only required to allocate a portion of the cost basis of his stock to the newly acquired rights for capital gain purposes.

The question of whether or not rights to purchase capital stock are treated as taxable income turns on whether or not the security to which the rights relate would be taxable income if distributed directly as a dividend. Generally speaking, if such a distribution would change the relative position of existing stockholders, then it is treated as taxable income; if it would not, then it is treated as non-taxable income. In our case any distribution of a new and additional series of preferred stock would have changed the relative position of existing stockholders and hence would have constituted a dividend taxable as income. Accordingly, the issuance to the common stockholders of rights to purchase such preferred stock did the same thing and thus gave rise to taxable income when the rights were exercised or sold.

If the company had issued to its common stockholders rights to purchase common stock (or debentures convertible into common stock), as was presumably done in the case of the other issues referred to in your letter, then no change in the relative position of existing stockholders would have resulted. However, after considering the advantages and disadvantages of various types of securities, the Board of Directors felt that the advantage to the common stockholders of being offered rights to buy convertible preferred stock (instead of common stock or debentures convertible into common stock) more than offset the tax disadvantage. Furthermore, even the tax disadvantage may be reduced by two other tax results: one, the cost basis of the common stock which you hold is unchanged; and two, the cost basis for the new preferred stock (in case your rights were exercised), it is subscription price increased by the value of your rights reportable as dividend income. Neither of these tax results would have followed if the value of your rights had not been treated as taxable income. ☆

Caution on using Zenz

THE CASE OF ZENZ V. QUINLAN (213 Fed.(2d)914) has been much discussed in these columns. In that case, the sole stockholder of a corporation sold a portion of the stock to a third party and thereafter sold the rest of his stock to the corporation. The District Court held that the purchase by the corporation was equivalent to a dividend, but the Court of Appeals reversed.

We pointed out that the fact that the taxpayer won on this issue in one court of appeals does not mean that the government will drop it. In Revenue Ruling 54-458, the government indicates that it will continue to scrutinize situations of this type, to look for family relationships which might make the redemption equivalent to a dividend. ☆

Too-thin incorporation can be attacked retroactively

THE DOCTRINE OF THIN incorporation was first referred to by the Supreme Court in the case of *Talbot Mills* v. *Commissioner,* 326 U.S. 521, decided in 1946. As a general rule, tax men have considered it applicable only to transactions arising thereafter. However, in the case of *The Gregg Co. of Delaware,* 23 T.C. No. 23, it was applied to a transaction which took place in 1933. This case should be an object lesson to all persons dealing with this situation. Even though your returns have been passed for a number of years, there is always the possibility that a revenue agent may apply this rule.

In this case, during 1933, a parent corporation transferred its foreign assets to the petitioner corporation in exchange for stock of the petitioner corporation and $1,000,000 of fifty-year 4% income notes. The notes were distributed immediately to the shareholders of the parent corporation. The petitioner corporation then transferred all of these assets to a Panama corporation for 10,000 shares of its 4% non-cumulative preferred stock. The shareholders of the parent corporation received the common stock of the Panama corporation.

After these steps had been transacted, the income of the foreign operations of the Panama corporation was paid over in the form of dividends on the preferred stock to the petitioner corporation. It then paid them out as interest on its income notes. The Commissioner took the position that the notes were in reality a form of invested capital, and treated the interest payment as non-deductible dividends. The Tax Court sustained the Commissioner and, as a result, the petitioner corporation lost its interest deductions. ☆

Timing to prevent double taxation in a liquidation

TIMING IS AN IMPORTANT ELEMENT in any tax case, and if it is desired to prevent double taxation in cer-

tain situations, it may be wise to take the steps one at a time, rather than combining them. Often the rules of general law are of no help in a tax case. In the case of *Glore* v. *U.S.*, DC Ill., 8/19/54, Glore was the sole owner of a corporation whose sole asset was a large interest in Adams Oil & Gas Corporation. Adams, a publicly held investment-trust, voted to liquidate in October 1943, but could not dispose of its assets and consummate the liquidation until February of 1944. Glore's company was dissolved in December of 1943. Adams' liquidating dividends in 1944 were paid to Glore. The Commissioner taxed this liquidating dividend to Glore's corporation, even though it had been dissolved before payment. The District Court refused to follow the Commissioner's theory. The court pointed out that until such time as final liquidation of Adams had been accomplished, it could have been revoked by its shareholders. Accordingly, Glore's corporation did not acquire an enforceable right to Adams' assets prior to the dissolution of its corporation, simply because Adams had voted to dissolve first. ☆

You don't always get capital gains on liquidation of a corporation

THE LIQUIDATION of one corporation, followed by the transfer of its assets to a new corporation controlled by substantially the same stockholders, is always a risky matter.

For example: in *William M. Lidden*, 22 T.C. No. 150, a stockholder who owned 20% of the shares indicated his desire to sell out due to poor health. The other stockholders did not wish to buy his stock. The majority shareholders formed a new corporation, which bought the major portion of the old corporation's assets. The old corporation then bought the minority shareholder's stock and distributed the remaining cash and property to the majority shareholders in liquidation.

It will be noted that, so far as the new corporation is concerned, property of a corporation was transferred to it and thereafter the holders of 80% of the stock of the old corporation controlled the new corporation. This type of transaction was a reorganization under Section 112(g)(1)(D) of the 1939 Code, and would be a reorganization under Section 368(a)(1)(D) of the 1954 Code. The Tax Court held, under the provisions of Section 112(c) of the 1939 Code, that the distribution of the property not transferred to the new corporation constituted a dividend received in connection with the reorganization which was taxable as ordinary income. The same rule would apply under Section 368(a)(2) of the 1954 Code.

As in this case, if any of the assets are not transferred to the new corporation, their receipt by the stockholders is considered a dividend. If the transaction is effected for the purpose of getting a stepped-up basis for the assets in the hands of the new corporation, it may very well fail. The *Lidden* decision is well written and refers the reader to the pertinent cases on the subject. It should be considered "must" reading for anyone who plans to dissolve one corporation and transfer a portion of its assets to another.

Revenue Ruling 54-500 is an excellent example of a somewhat similar transaction, but it did not result in ordinary income to the stockholders. In that case, the corporation involved was conducting two businesses. The shareholders transferred 70% of their stock to a new corporation, in which they held only a minority interest. Thereafter, the old corporation was dissolved, and the assets relating to one business went to this new corporation and the stockholders received the assets of the other business. The Commissioner ruled that the dissolution of the corporation was to be considered a complete liquidation resulting in capital gains to the stockholders. As to the taxability of the transfer of assets to the new corporation, however, he refused to rule prior to the examination of the returns on which the transaction would be reflected.

The safest way to realize capital gains is through the sale of the asset involved. When the asset is a majority interest in stock of a corporation and the purchaser is the corporation, a situation is present which causes the Commissioner to look twice. In Revenue Ruling 54-408, the Commissioner sets forth one factual situation under which he ruled that the gain would be considered a capital gain. In that case, the shareholder was to continue in the employ of the company. The ruling will save a lot of work for anyone faced with a similar situation. ☆

Special caution needed when foreign corporation used

UNDER SECTION 112(i) of the 1939 Code (and Section 367 of the 1954 Code) when a reorganization involves a foreign corporation, the Commissioner must be satisfied that the purpose of the transaction is not to avoid United States income taxes. The reason for the enactment of this section was that many taxpayers were putting their assets in foreign corporations in tax-free transfers. The foreign corporations would then realize a tax-free profit on the property, and either lend the proceeds to the taxpayers or retain them as property in the foreign country, free of United States taxes.

In Revenue Ruling 54-499, the Commissioner ruled that a particular reorganization with a Canadian corporation would be tax free. The ruling sets forth the various factors which the Commissioner considers important in these cases. It should be read by everyone who is interested in a transaction of this type. Actually, the particular type of reorganization involved was a routine one, which would normally not require an advance ruling from the Commissioner. Since a foreign corporation was involved, however, it was necessary that the ruling be obtained. [For further discussion of the foreign tax aspects of this situation, see page 125. Ed.]

New decisions

102 penalty on corporation which made large emergency loan to stockholder. In 1949, taxpayer, which had never paid dividends and had a surplus of over $200,000, made a $145,000 loan to enable its stockholder to pay back taxes. A dividend was discussed but deferred in fear of business troubles over the publicity about stockholder's prison sentence. A dividend was paid in 1950. The accumulation, largely in cash, was held unreasonable for 1949. *Al Goodman, Inc.*, 23 TC No. 39.

Fair value of oil properties. Taxpayers owned 51% of an oil lease operating corporation. They and the two other owners sold $^3/_4$ of their stock. Taxpayer retained 17% interest. Shortly thereafter, the new controlling stockholders liquidated the company, and taxpayer received an undivided 17% interest in the assets, sold four months later for about $860,000. Taxpayer originally valued the liquidating distribution at about $890,000. Apparently in order to claim a loss on the sale four months later, he increased the value at liquidation to $1,475,000. In a brief opinion, the court holds merely that the value of the 17% interest was $1,050,000. *Ellwood* v. *U.S.*, DC Tex., 11/26/54.

Dividends v. repayment of indebtedness. No real creditor-debtor relationship was established between a corporation and a husband and wife, its chief officers and stockholders. The corporation upon formation had issued stock of $49,000 and notes to stockholders of about $232,000 for partnership assets worth $281,000. All other corporate debts were given preference by subordination of stockholder loans. Some of the stockholder loans were not paid at maturity. Thus, no interest deduction is allowed on these loans. Payments to the stockholders did not constitute payments of bona fide indebtedness but were distribution of corporate profits taxable as dividend income. *Gooding Amusement Co.*, 23 TC No. 50.

Organization expense not deductible in year of tax-free merger. The expense of organizing a corporation cannot be deducted in the year it is merged tax free. The theory of the law is that such a merger is not to be treated as ending the corporation venture. *Bryant Heater Co.*, TCM 1954-201. [See also below, Editor.]

Notes held to be securities issued in tax-free exchange and not part of basis of property. [Acquiescence.] Taxpayer claimed that there should be included in the basis of land and buildings it acquired, notes issued to its stockholders for valuable contract rights they owned affecting the corporation's land. The court found that the notes (being subordinate to large bank loans) represented substantially a long term equity interest and were "securities" issued in the tax-free exchange—the creation of the corporation. Hence the basis of the contract rights to the corporation was the basis to the stockholders. In fact, the notes were paid off in two years. *Camp Wolters Enterprises, Inc.*, 22 TC No. 94, *Acq. IRB* 1954-47, 5.

Deficit carried over in tax-free reorganization. In a tax-free reorganization a corporation assumed all the assets and liabilities of a Massachusetts trust. At the time of reorganization the trust had a substantial deficit. In the following years the corporation showed a net profit unless the deficit was carried over. In 1950 the corporation made a cash distribution to the taxpayers. This distribution exceeded the profit of the fiscal year and was therefore in part either a return of capital or taxable income of prior years depending on whether the deficit could be carried over. The court distinguished the *Phipps* case (366 U.S. 410) which disallowed the offset of a predecessor's deficit against earnings existing at the time of reorganization. The court held the distribution to be a return of capital and noted that the 1954 Code made specific provision therefor. *Snider* v. *U.S.*, DC Mass., 11/2/54.

1933 reorganization tax-free—old stockholders kept 50% of "break up" value. The question at issue, taxpayer's basis of assets sold in 1948–49, depended on whether a 1933 transaction was tax free under the law which then permitted it if transferor retained 50% interest in the new company. As the Court computed going concern value (capitalizing six years income at 10%) and break up value, the old stockholders retained through their preferred stock in the new company, at least a 50% interest. *Bryant Heater Company*, TCM 1954-201.

Subsidiary had income despite lease paying all to parent; not estopped from claiming it in base period. (*Acquiescence.*) Taxpayer had a lease contract with its parent whereby it paid over all its net income. Taxpayer now contends that the lease should be disregarded for tax purposes and it should be allowed a base period income. This it agreed would permit the Commissioner to open those income tax years because of its inconsistent position. The Court agrees the taxpayer had income in the base period and is not estopped from showing it. The Commissioner knew the facts and there was no misrepresentation. There was simply an erroneous interpretation of law by both parties. *City Machine & Tool Co.*, 21 TC 937, *Acq. IRB* 1954-47,5.

Interest on debenture bonds, paid by guarantor, is taxable. The taxpayer received interest on debenture bonds under a collateral agreement, guaranteeing interest but not principal, after complete exhaustion of the assets of the issuing corporation. This is fully taxable; any loss on the bonds will be deductible in the year in which they mature or are disposed of. *Rev. Rul.* 54-563.

$145,000 advance to stockholder held loan not dividend. The Court held that $145,000 advanced to the dominant stockholder so that he could pay back income taxes and so secure a reduced prison term, was a true loan. It was secured by collateral, and the intent was always to repay it. *Al Goodman, Inc.*, 23 TC No. 39.

No error in letting jury decide whether redemption is equivalent to dividend. The government argued that under all the facts put in evidence, a redemption of preferred stock was taxable as a dividend as a matter of law, and the court erred in giving the question to a jury (which found for the taxpayer). The Tenth Circuit holds that where, as here, the jury could properly find a substantial business motive, an issue of fact was presented which was properly for the jury. *Griffin, Jones* v., CA-10, 11/15/54.

Payments on preferred stock not deductible as interest. In a very brief finding of fact and conclusion of law, the court holds that preferred stock was not debt, and dividends paid on it were not deductible as interest. *Crawford Drug Stores* v. *U.S.*, DC Okla., 6/29/54.

Liquidation in one month does not require dissolution. Under the 1939 Code stockholders pay no capital gains tax on unrealized appreciation of corporate assets received in a liquidation carried out in any calendar month. (They pay dividend tax on surplus distributed.) This section, the Service holds, does not require that formal dissolution and surrender of the corporate charter occur in the month. Only actual, de facto, distribution of all assets is required. *Rev. Rul.* 54-518.

NEW DEVELOPMENTS IN

Taxation of oil & gas

EDITED BY GODFREY WM. WELSCH, LL.B., CPA

Is a joint venture a partnership for deducting intangible drilling costs?

THE ELECTION to deduct intangible drilling and development cost for income tax purposes has been one of the most important factors in the discovery and development of the oil and gas resources of the United States. Despite this fact, the 1939 Code and prior revenue acts contained no specific language which would permit the deduction of such costs, and the right to make the election was dependent upon regulations issued by the Commissioner. When, in 1945, the Court of Appeals for the Fifth Circuit challenged the validity of these regulations in *F. H. E. Oil Co.* v. *Commissioner* (147 F. 2d 1002, rehearing denied 149 F. 2d 238, second motion for rehearing denied 150 F. 2d 857, *affg.* 3 T.C. 13) the entire petroleum industry was up in arms. Counsel for at least thirty oil producers filed briefs as *amici curiae* in the first rehearing motion. Although denying the motion, the Fifth Circuit restricted its holding to the facts in the case. In an effort to eliminate doubt as to the general validity of the election to expense intangibles, Congress, on July 21, 1945, passed a concurrent resolution affirming that the regulations were in accordance with and had the full force and effect of law. This concurrent resolution, together with the announcement by the Treasury that it would recognize the regulations and not attack them in the courts, seemed to lay the matter at rest. However, in denying the second motion for rehearing in the *F. H. E.* case, filed after the passage of the concurrent resolution, the Court said:

Nature of the Resolution

"Opinion. . . . The Resolution is not an Act of Congress approved by the President or passed over his veto. It does not make law, or change the law made by a previous Congress and President. . . . As an expression of opinion on a point of law it would of course be entitled to most respectful consideration by the courts, which under the Constitution exercise the judicial power."

No new election granted

Thus, when the House of Representatives' version of H.R. 8300 did not contain any reference to the election to deduct intangible drilling and development costs in the case of oil and gas wells, grave concern was felt among oil and gas producers that the election might again be the subject of court or Treasury attack, particularly in view of Section 263(a) which stated the general rule that no deduction shall be allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate, and then exempted from this general rule expenditures for the development of mines or deposits, research and experimental expenses, and soil and water conservation. Representatives of the oil and gas industry and legal and accounting advisers to petroleum producers pointed out to the Senate Finance Committee the omission of intangible drilling and development costs from the exceptions to the general rule. Recognizing the equity of the complaint, the Senate Finance Committee added Section 263(c) to H. R. 8300. This section, which is in the Internal Revenue Code of 1954 as finally enacted, provides that

"Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress."

This authorization for the Secretary or his delegate to issue regulations permitting the election to deduct intangible drilling and development costs finally eliminates all doubt as to the legality of the regulations but it does not grant any new right of election. Unless such right is given by the Secretary in future regulations to be issued, taxpayers who failed to exercise a timely election to deduct such costs under the current regulations will be required to capitalize such expenditures made in future years.

Regulations 118, Section 39.23(m)-16 provides that the election is to be made by "the taxpayer." There is no problem where an oil and gas property is owned and operated by a sole proprietorship or a corporation. Prior to the decision of the Tax Court in *Bentex Oil Corp.* 20 T.C. 565, there appeared to be no problem in connection with joint operation of a leasehold or even in connection with drilling and development costs incurred by a bona fide partnership. As neither the joint venture nor the partnership was a "taxpayer," it was generally assumed that the election was to be made by the individual participants, although in the interests of caution, tax advisers usually suggested that partnership returns and joint venture returns indicate unequivocably that the election was being made. In the *Bentex* case, the Tax Court held that a joint lease operation was a partnership and that such a partnership was the proper party for making the election to expense intangible drilling and development costs.

Relation of Bentex and Ruling 54-42

This decision was followed by Revenue Ruling 54-42 which did not clarify whether or not a joint lease operation was in fact a partnership but which did provide that the election to expense intangible drilling and development costs incurred in connection with the oil operations of a partnership that files its returns and computes its income on Form 1065 is exercisable only by the partnership. The Ruling further provides that the partnership election is controlling irrespective of the elections of the individual partners as to their own operations. Revenue Ruling 54-42 relies for support on the *Bentex* case and on I.T. 3713, 1945 *Cum. Bull.* 178.

In a paper which he presented be-

fore the Tulsa Conference of Accountants recently, W. Leo Austin, attorney with the Atlantic Refining Company in Dallas, made an excellent analysis of the *Bentex* decision, Revenue Ruling 54-42, and the application of this decision and ruling to joint lease operations generally. We have gotten Mr. Austin's permission to bring you a digest of this analysis, as follows:

"In order to put Revenue Ruling 54-42 in its proper perspective, it is necessary that we briefly review the facts and the Tax Court decision in the *Bentex* case. The question for decision of the Tax Court was whether the petitioner, in computing its excess profits credit for the years 1944 and 1945, was entitled to capitalize its proportionate share of the intangible drilling and development costs of a certain co-owned oil and gas lease for the years 1938 and 1939. Bentex had elected to capitalize intangible drilling and development costs on its 1936 corporation income tax return. In 1938 and 1939, however, Bentex, with its other co-owners, undertook to expense and deduct such costs in arriving at the proportionate share of profits or losses of the respective co-owners from the joint lease operations. The joint venture filed partnership returns on Form 1065 for each of these years on which the income and expenses were shown in some detail. These returns disclosed the profits or losses distributable to the members of the joint venture in proportion to their respective interests. Each of the returns stated that the nature of the organization was a joint venture.

"The 1938 and 1939 joint venture returns were examined by revenue agents and the deductions were disallowed. Bentex and its operating co-owner protested and argued that the co-owned lease operations constituted a partnership and possessed the right to elect to deduct these intangible drilling and development costs and the Commissioner conceded the issue. Bentex here contends that it acted erroneously in 1938 and 1939 and that the intangible costs should be capitalized and its proportionate share of the results of the operations of the joint venture recomputed for determination of its excess profits credit under the income method.

"Bentex made two contentions before the Tax Court, the first one being that the co-owned lease operations were not a partnership or joint venture and, therefore, had no right to exercise an option in 1938 and 1939. Its second contention was that if the operations were held to be a partnership or joint venture, it was not a "taxpayer" within the meaning of Section 181 of the Code and, consequently, had no right to an option under Article 23(m)-16 of the Regulations.

"The Tax Court rather summarily disposed of the first contention by stating that it entertained no doubt that during the years 1938 and 1939 the joint lease operation was a joint venture or partnership within the broad definition of that term in Section 3797 of the Code.

"With respect to the second contention, the Tax Court held that the organization of the joint venture brought into being a new entity, which, while not a taxpayer, had a very important role as an income producing and computing agency. In support of this conclusion the Court said that in computing its net income under the revenue laws, it is generally the partnership, not the individual partner, that exercises the various options open to taxpayers in computing net income under the Code. In support of this conclusion the Tax Court cited *H. H. Wegener*, 41 B.T.A. 857, and *John G. Scherf, Jr.*, 20 T.C. 346. In the *Wegener* case the Board held that a joint venture had a right to elect to treat intangible development costs as ordinary and necessary expenditures in its income tax return and when it did not do this, it obviously elected to capitalize them. In the *Scherf* case the partnership elected to report the capital gain from the sale of certain assets on the completed transaction basis and it was held that the partner could not elect to report his distributive share of such gain on the installment method.

Underlying considerations in co-owned operations

"In considering the possible application of Revenue Ruling 54-42 to co-owned oil and gas lease operations generally, we should first review what I consider the fundamental considerations. In the first place, Bentex got into difficulties by blowing both hot and cold on the same issue. When the particular returns on Form 1065 were filed for the years 1938 and 1939, Bentex was aware of the fact that it had elected to capitalize intangible development costs in its 1936 corporation return; nevertheless, the same costs incurred by the joint venture in 1938 and 1939 were charged to expense. When the Commissioner and his agent disallowed these expenditures Bentex protested and the Commissioner conceded the issue. This particular organization's right to the election was thus established.

"Another point that I think worthy of consideration is that the joint venture in the *Bentex* case filed a complete return on Form 1065 on which all income and expenditures of the joint venture were shown and the income and loss was distributed thereon to the members in proportion to their respective interests. It is worthy of note, also, that on the returns the type of organization was stated to be a joint venture; whereas in the protest filed to the Commissioner's action in disallowing the drilling costs, the petitioner designated the joint lease operation as a partnership and strongly contended that it was such.

Not applicable generally

"I believe that the foregoing discussion gives the background and reasons for the *Bentex* decision, but at the same time I do not hold to the view that the decision and the resulting Revenue Ruling 54-42 are necessarily applicable to joint lease operations generally. To my mind the usual joint lease operation is not a true partnership. It is merely an arrangement, usually in writing, between the co-owners of an oil and gas lease whereby one of the co-owners undertakes to develop the co-owned property and in the process collect from his co-owners their respective proportion of all costs of development and operation. The operating co-owner usually incurs all costs of development and operation in his own name and the parties with whom he deals do not usually know who his co-owners are. The operating co-owner cannot bind and obligate his co-owners as he could do if the operation were a true partnership. The co-owners usually agree in writing that the operating co-owner cannot incur obligations binding upon the non-operating co-owners beyond a specified amount without first securing their approval. In the majority of instances, the joint venture as such never receives the proceeds of production and certainly the operating co-owner does not have the power to sell the co-owners' production and receive the proceeds therefrom.

"Another consideration present is

that co-owned lease operations are reported on Form 1065 in accordance with the permission granted by the Commissioner of Internal Revenue in I.T. 2785, XIII-1 *Cum. Bull.* 96. This ruling held that in the case of co-owned oil and gas leases it will be considered sufficient compliance if a return on Form 1065 is filed by the operating co-owner under the operation co-owner's name which will show the name and location of the property, the names of the co-owners, their percentage of interest, the co-owners' interests in production stated in terms of barrels of oil and thousand cubic feet of gas, total costs billed, and revenue credited. The information is required by I.T. 2785 in lieu of filling in the several items and schedules on the partnership return, Form 1065. In the majority of instances the information as to the revenue is not shown because the operating co-owner does not have that information in his records of the operations of the co-owned property.

"It is my opinion that the Internal Revenue Service will not apply the *Bentex* decision and Revenue Ruling 54-42 to those co-owned oil and gas lease operations that have filed reports on Form 1065 in accordance with the provisions of I.T. 2785. In other words, I believe you are fairly immune from the provisions of Revenue Ruling 54-42 if you have reported joint lease operations in accordance with I.T. 2785 and have not taken an inconsistent position by claiming that the co-owned lease operations are partnerships for purposes of securing a tax benefit under other sections of the Internal Revenue Code.

"With respect to I.T. 2785 compliance, I understand that as a matter of practice the Service has not required I.T. 3930 groups to file the return so long as each member files the proper schedules with his own return. Either the group organization complies or each member must file the proper schedules."

Partnership provisions of new Code

It can be seen from Mr. Austin's discussion that he is of the opinion that neither the *Bentex* case nor Revenue Ruling 54-42 applies to the ordinary joint lease operation. What, however, are the effects of the partnership provisions in the 1954 Code? Section 703 (b) reads as follows:

"Elections of the Partnership.—Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under Section 901 relating to taxes of foreign countries and possessions of the United States, shall be made by each partner separately."

The report of the Senate Finance Committee states

"Subsection (b) requires that all elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. Thus, elections as to methods of accounting, methods of computing depreciation, the use of the installment sales provision, the option to expense intangible drilling and development costs, etc., must be made by the partnership, and must be applicable to all partners equally . . ."

Thus, in effect, Revenue Ruling 54-42 has been enacted into law and there can be no doubt that when a partnership exists, the election to expense intangible drilling and development costs must be made by the partnership. Presumably, each new partnership will have a new election.

But, the question remains—is the ordinary joint lease operation of the type referred to in I.T. 3930, *supra*, a "partnership" within the meaning of the above quoted provision?

Section 761(a) defines a partnership to include

". . . a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."

Many practitioners disagree

Despite this all-embracing definition, many eminent tax practitioners are of the opinion that a joint lease operation is not necessarily a "partnership" within the meaning of the 1954 Code. This opinion is based on the nature of a joint operating agreement, the history of joint operations under prior tax laws, previous Treasury rulings, and the almost impossible administrative burden which the Treasury would undertake if it attempted to apply the partnership provisions of the 1954 Code to the multitude of joint lease operations carried on throughout the United States.

The situation is by no means free from doubt, particularly in view of the provision in Section 761 which provides:

"Under regulations the Secretary or his delegate, may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for the active conduct of a business, or

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income."

The Committee Reports throw little light on this provision but it would appear that Congress was attempting to alleviate the administrative burden which would result from the classification of a joint lease operation as a partnership, while at the same time permitting such operations to be so classified if such classification were desirable to the participants for the purposes of new elections, etc., by leaving with the participants the option as to how each operation would be treated. The type of operation which is permitted to be excluded from the partnership provisions of the new Code is on all fours with the type of operation covered by I.T. 3930 and the only point which would appear to be at issue is whether or not a joint lease operation is an "unincorporated organization."

Until there is further clarification, by regulations, court decisions, or legislature, as to whether or not a joint lease operation is covered by the partnership provisions of the 1954 Code, it would appear advisable in each instance to file a Form 1065 and either elect to be excluded from the partnership provisions of the Code, in the manner to be provided by the regulations to be issued, or elect to expense intangible drilling and development costs. Where a participant in a joint lease operation has never previously incurred intangible drilling and development costs, such participant should similarly elect, in his own return for the first year in which the joint operation incurs such costs, to expense intangible drilling and development costs in order to protect his right of election in the event that joint operations should later be determined to be excluded from the definition of a partnership. ☆

NEW DEVELOPMENTS IN

Taxation of mining

EDITED BY CHARLES J. BUSICK, CPA

Percentage depletion basis used in some agents' examinations

RETURNS FOR THE FIRST several years affected by the 1951 Revenue Act have recently been examined or will be examined in the very near future, Donald J. Kester points out in the *CPA Spokesman* (published by the Pennsylvania Institute of CPAs). He says a very practical approach has been taken by the Internal Revenue Service in examinations with which he has had personal contact. The list of natural resources subject to percentage depletion was greatly expanded by the 1951 Act, he continues, and the introduction of different depletion rates for products of the same mine posed many problems for taxpayers with no previous contact with the complexities of Section 114.

While original returns may have treated a property as subject to only one depletion rate based upon chemical content or some other test, the approach that has been used in examinations is to separate sales into more than one depletion rate class based upon end use. Depletion was then computed separately in each rate class. This approach requires an analysis of sales not only in the year in question, but also requires a similar analysis for base years, where exempt excess output is involved.

Voluminous sales analysis into end use classifications might be avoided by use of reports previously made to other governmental departments, as was used in one case not only for the year in question but for the base years. Conversion of quantities and sales dollars to the first marketable product will in most cases be based upon the sales analysis of the finished product.

This breakdown of production presents the problem of allocation of direct costs to production in each depletion rate class. Evidently following the second example given in Section 40.453-3 (a) (4) of Regulations 140 relating to the Excess Profits Tax, direct costs were allocated to each of the depletion classifications on the basis of total sales dollars of the particular classification. Selling, general and administrative expenses were allocated on the same basis. This method of allocation results in the same percentage of profit before depletion for each depletion rate class and could result in a radically different depletion deduction for the property as a whole than would be arrived at by the use of the taxpayer's cost records or a direct allocation of specific costs.

It is interesting to note that the analysis of sales by depletion rate classes may entitle one of the depletion classes to the benefits of exempt excess output under the general or "percentage of recoverable reserves" method, despite the fact that total production of the property will not meet the same test.

Even if no depletion rate class of product will meet the general test, it is possible that by applying the end use test to the taxable year and the base years it can be shown that there has been an increase in sales of a particular product which is covered by the alternate methods of computing exempt excess output and requires no reference to recoverable reserves. The alternate computations are based on unit net income for the taxable year. The method of allocation of expenses used for percentage depletion should be used here and may have a material effect on the income to be excluded.

The methods used in some agents' examinations indicate the possibility of either increases or decreases in the amounts claimed on the original returns. It may therefore be advisable to review past returns to determine if a strict application of the end use test in the classification of sales by depletion rate class and the method of allocating costs give rise to any substantial change in the percentage depletion or exempt excess output claimed.

There is no intention to imply that all percentage depletion computations will need to be or should be made on the basis or method set forth. On the contrary, in some cases an entirely different approach may be necessary, but it is hoped that a brief outline of the basis used in some agents' examinations will be of help to practitioners facing the same problems. ☆

Land, not option, sold; short term capital gain results. *[Certiorari denied.]* Taxpayer had an option to purchase a mineral property and gave a suboption to a mining company. When the latter gave notice of its intent to exercise its suboption, the taxpayer exercised the main option (more than 6 months after acquisition) naming the mining company as purchaser in its stead. The Eighth Circuit affirmed the District Court in holding that a short-term capital gain on the sale of land rather than a long-term capital gain on the sale of the option resulted. The Circuit Court pointed out that the suboption not only made no mention of the main option but had an earlier expiration date. *Barber* v. *U.S.*, 215 F. 2d 663; *cert. den.*, 12/6/54.

First-year oil and gas lease rentals deductible. *[Nonacquiescence.]* Tax Court sees no reason why first-year rentals payable on oil and gas leases should not be deductible as are subsequent-year and delay rentals. "Both are fixed sums paid in advance to secure to the payor the right to hold the lease . . . without the necessity of drilling wells or making further payments, except royalties on mineral produced. In contrast to royalties, which are not paid for time, but for oil and gas, taken or to be taken, . . . rentals are not subject to depletion by the payee." Taxpayer was therefore permitted to deduct first-year rentals paid. *Olen F. Featherstone*, 22 TC No. 96., *Nonacq.* IRB 1954-47.

Percentage depletion allowable on production payments received for use of mine equipment. The Service holds that in computing his income on which percentage depletion is computed, a lessor must include "rental" payments for the use of the lessor's plant and equipment when the payments are measured by production. If the rentals are measured by time, the lessor may take depreciation, not depletion. *Rev. Rul.* 54-548.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & BYRON F. WHITE, LL.B., CPA

Depreciation questions and answers under 1954 Code in light of proposed Regulations

by BENJAMIN HARROW, J.D., CPA

AS THE NEW DEPRECIATION RULES under the 1954 Code have been analyzed by tax men, many specific questions have had to be held in abeyance pending release of the Commissioner's Regulations. Now that we have the draft of the proposed Regulations, we can reassess the depreciation picture completely. These questions and answers which follow combine the new statutory provisions with the proposed Regulations, thus integrating the whole depreciation picture as it appears at the moment.

Q. What is the sum of the years digits method of computing depreciation?

A. Under this method changing fractions are applied each year to the cost of depreciable property less salvage value. The fraction for each year is the number corresponding to the remaining useful life divided by the sum of all years digits in the estimated life. For example if an asset has a five year life for the first year the number corresponding to remaining useful life is five. The sum of all years digits is $5 + 4 + 3 + 2 + 1$. Hence depreciation for the first year is $^5/_{15}$ of the cost. For subsequent years it is $^4/_{15}$, $^3/_{15}$, $^2/_{15}$, and $^1/_{15}$, respectively.

Under the sum of the years digits method recognition is given to the fact that an asset depreciates more heavily during the earlier years of the life of an asset. For example if an asset costs $50,000 and has an estimated life of 5 years, the depreciation for the first year is $16,667 ($^5/_{15}$ of $50,000). For the second year it is $13,333 ($^4/_{15}$ of $50,000) and for the third year it is $10,000 ($^3/_{15}$ of $50,000). Under the straight line method the depreciation for the third year would also be $10,000.

Q. How do you compute depreciation under the sum of the years digits method if the asset was acquired during the year?

A. Suppose an asset costing $1,500 with a five year life was acquired on April 1, 1954. The depreciation allowance for 1954 would be $375 ($^9/_{12} \times {}^5/_{15}$ of $1,500). For 1955 it would be $^3/_{12} \times {}^5/_{15} \times$ $1,500 plus $^9/_{12} \times {}^4/_{15} \times$ $1,500, or $425. For 1956 it would be $^3/_{12} \times {}^4/_{15} \times$ $1,500 plus $^9/_{12} \times {}^3/_{15} \times$ $1,500 or $325. This illustration is given in the proposed regulations.

Q. Is the sum of the years digits method more favorable to the taxpayer than the declining balance method?

A. Either method is available to a taxpayer, subject to three limitations. The property must have a useful life of at least three years. If the property is acquired after December 31, 1953, the original use of the property must commence with the taxpayer after December 31, 1953. If property is constructed, reconstructed, or erected either method may be used but only on the portion of the basis constructed, reconstructed, or erected after December 31, 1953.

Under the declining balance method no salvage is taken into account. It is under the sum of the digits method. If the declining balance method were used in the first question the depreciation allowance for the first year would be $20,000 (twice the amount under the straight line method). This compares with $16,667 under the sum of the years digits method. For the second year the depreciation under the declining balance method would be $12,000 as compared with $13,333 under the sum of the years digits method. If a taxpayer is considering only the first year's depreciation the declining balance method would be more favorable. If later years are taken into consideration the sum of the years digits method may be more favorable.

Taxpayer should take into account one other factor. He may change at any time from the declining balance method to the straight line method. This may be done without special permission from the Commissioner. In the above illustration the unrecovered cost at the beginning of the second year is $30,000 and the remaining useful life is four years. Taxpayer could depreciate this cost over four years, $7,500 each year.

Under the sum of the years digits method the taxpayer could not change to any other method without permission. The regulations say that any change in method of depreciation is a change in method of accounting and such a change may be made only with the consent of the Commissioner.

Q. If a taxpayer in 1954 elects to use the declining balance method at 200% of the normal straight line rate, on a class of assets acquired in 1954, may he in 1955 reduce the rate to 150% and still be considered as using the declining balance method?

A. The proposed regulations say that under the declining balance method a uniform rate is applied each year to the unrecovered cost. With respect to the rate the regulations say that it shall not *exceed* twice the normal straight line rate. In our opinion the taxpayer could under the regulations reduce the rate from 200% to 150%.

Q. Suppose a taxpayer acquired a fleet of autos in 1954 and elected to use the declining balance method of 200% of the straight line rate. In 1955 the taxpayer adds to the fleet and elects to use the declining balance method at a 150% rate. May he do so?

A. The proposed regulations say that any election to depreciate property shall not be binding with respect to any property acquired in a subsequent taxable year. The taxpayer could therefore depreciate one fleet according to one method and a fleet acquired in a later year on a different method.

Basically the taxpayer is limited to a reasonable allowance for exhaustion, wear, and tear. The allowance, says the proposed regulation, is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside will at the end of the useful life of the depreciable property equal its cost.

What the new code really does is to introduce methods of computing depreciation that will allow a greater deduction in the earlier years of the life of an asset instead of spreading the deduction equally over its life as is done under the straight line basis. The deduction is still based upon the estimated life of the asset. That is not accelerated as it would be under the amortization provisions in the Code.

Q. A taxpayer in 1954 purchases a depreciable asset that has a useful life of ten years if it is in use. It will become obsolete in 20 years. Since its purchase the asset has been idle although it is intended eventually to use the asset. May the declining balance method or sum of the years digits method be used and would the deduction be computed on the basis of a ten year life or 20 year life?

A. The proposed regulations say that any reasonable and consistent method of computing depreciation may be used. "Whatever method is adopted, due regard must be given to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The deduction for depreciation is concerned with the remaining useful life of depreciable property. It is not clear from the question whether the useful life is ten years or 20 years. On the assumption that it is 20 years, the special methods may be used for determining the deduction. If at the end of any year it is determined by the taxpayer that the remaining useful life is less than the 20 year basis originally assumed, he may change, without the consent of the Commissioner. However if the reasonableness of the deduction is questioned, the taxpayer must substantiate the reasonableness by a clear and convincing showing that there is a basis for the change. If the taxpayer wanted to change from a declining balance method to a straight line method the regulations themselves provide that no consent is necessary. If the change is to any other method, the consent of the Commissioner is necessary, since such a change is a change in method of accounting and under Sec. 446 consent is necessary.

Q. If a composite rate of depreciation was used prior to the new Code with respect to a ship, can capital additions to that ship in 1954 be treated separately to take advantage of the benefits of the new depreciation provisions?

A. The new methods apply to property acquired after 1953. The capital additions may be treated as separate assets and separately depreciated. The regulations give an illustration of a building with a total basis of $100,000. The portion attributable to construction after 1953 is $30,000. The declining balance method at 200% of the straight line rate or the sum of the years digits method could be used only for $30,000 the portion of basis attributable to the construction after 1953.

The regulations provide that any method selected must be applied to a particular account consistently thereafter. That would be applicable to a method selected for the first time in 1954. It would not be applicable to a method used in 1953. The ship could be treated as one item and additions as separate items. In fact with respect to 1954 additions the declining balance could be used. 1955 additions could be depreciated on the sum of the years digits method. The regulations provide that depreciation should be recorded on taxpayer's books, and with express reference to specific items or groups of property. The regulation also provides that if a taxpayer does not desire to have his regular books of account show all the factors entering into the computation of depreciation allowances, the factors should be recorded in auxiliary records which shall be kept with and reconciled with the regular books of account. ☆

New Code extends Journal Tribune rule that lessee can expense machinery

THE EIGHTH CIRCUIT has reversed the Tax Court in the taxpayer's favor to allow as a deduction in the year purchased the full cost of machinery purchased by the lessee taxpayer as part of the lease agreement. The case contains an interesting accounting issue with respect to Section 462 of the 1954 Code.

The Journal Tribune Publishing Co. leased a newspaper plant and equipment for a 99-year period, contracting as part of the lease agreement to replace and repair worn equipment. The Commissioner disallowed the taxpayer's deductions for machinery and equipment replaced by the taxpayer in the year 1948 on the ground that assets acquired by the expenditures had a useful life of more than one year. The Tax Court (20 TC No. 92) agreed with the Commissioner that the expenditures were made for capital assets and must, therefore, be recovered over the useful life of the assets acquired or the remaining term of the lease if shorter.

The Eighth Circuit Court (10/26/54) reversed the Tax Court, pointing out that in so far as the taxpayer replaced equipment which it was obligated to maintain under the lease, expenditures therefore were deductible even though the equipment had a useful life of more than a year.

We believe the Circuit Court's opinion was sound and think from an accounting, as well as legal standpoint, the theory of the deduction is correct. The theory is best stated in *Illinois Central R.R.* v. *Commissioner* (90 F. 2d 458 (1937)):

"In the present case the leases included some 2,300 units of equipment, a substantial number of which were replaced in order to keep the leased property in operation as a going concern. Such expense of replacing the retired units of equipment was necessarily made to 'keep the properties going' and not 'to create additions to them'. They constituted not investment, but upkeep, which the lessee was obligated to perform by the terms of the lease and was required to do so in order that it might continue the use of the property in the business for which it was acquired."

The Circuit Court in the instant case

distinguished cases relied on by the Tax Court (*Duffy* v. *Central R.R.*, 268 U.S. 55 and *Nelson* v. *Commissioner*, 184 F. 2d 649) on the basis that in those cases the machinery was purchased as addition rather than replacement, and that the purchases were made not pursuant to the lease contract but clearly for additional property.

Under the 1954 Code, we believe that the taxpayer can achieve an even greater tax benefit than he received under the Eighth Circuit's interpretation of the 1939 Code. The pertinent 1954 Code section is 462:

"Reserves for Estimated Expenses, etc., (a) In computing taxable income for the taxable year, there shall be taken into account a reasonable addition to each reserve for estimated expenses to which this section applies."

The section is available to accrual taxpayers who make the election.

Apparently the lessee can apply Section 462 to a lease obligating it to replace the machinery and equipment at the termination of the lease. Seemingly, the statute allows a deduction to cover the depreciation of the leased property in the years it depreciates rather than in the year of a replacement purchase, as in the *Journal Tribune* case.

Consider a taxpayer who leases in 1955 a building furnished with a new machine with a four-year-life expectancy purchased by the lessor at a cost of $1,000. Assume the lease requires the lessee to replace the machine when worn out and to leave the property in a condition similar to its original state. Under the 1939 Code, and the Circuit Court's decision in the *Journal Tribune* case, the taxpayer could take no deduction until 1959 when he will purchase a new machine for $1,000 to replace the old one. However, under Section 462, he probably can deduct yearly in 1955, 1956, 1957, and 1958 $250 as a reasonable addition to a reserve for the estimated expense of replacing the machine in 1959. Under this interpretation of Section 462 such upkeep and replacement leases give the lessee maximum current tax advantage. ☆

New accounting decisions this month

Payments on guaranty of corporate borrowing are not due to debt becoming worthless; are deductible as a loss. Taxpayers, stockholders and officers of a builder of prefabricated houses guaranteed any loans a bank might make to it. They paid off such loans at a time when the assets of the corporation were far below its debts. The Circuit Court agrees with the District Court that the loss did not arise out of a debt becoming worthless, therefore the rules on deductibility of bad debts (business and nonbusiness) are not applicable. The deduction is allowable simply as a loss on a transaction entered into for profit. *Allen, Edwards* v., CA-5, 11/16/54.

"Bonds—purchased—flat" rule applied to rent on land trust certificate. Taxpayer purchased certain land trust certificates after a plan for the reorganization of a hotel-operating corporation had been approved. Under the plan, the corporation was to pay the trustee a "rent" of 5% of the face amount of the certificates plus "additional rent" equal to one half the corporation's profits. Shortly after taxpayer purchased his certificates, at a premium, the additional rent for several years was paid to him. The Tax Court held that if this had accrued prior to taxpayer's purchase, the receipt was return of capital; it found that one-half the profits had been determined, and therefore accrued, prior to that time. This court holds that it was uncertain how much of the additional rent would be withheld for the expenses of the reorganization, and points out that the bankruptcy court did withhold about one fifth. Consequently, the taxpayer's right did not accrue till that portion was fixed, which occurred after its purchase, and the receipt was income. *McDonald* v. *Comm'r.*, CA-6, 12/9/54.

Stock of co-op apartment not worthless until deficiency judgment in excess of assets is entered. Taxpayer, in 1920's, had promoted a cooperative apartment venture in which it still held some stock in 1945, when the building was foreclosed. The mortgage was some $400,000 in excess of the figure at which the foreclosing mortgagor resold the building, and it was clear that a substantial deficiency judgment would be entered. The balance sheet of the co-op showed only some $40,000 of assets at 12/31/45. However, the Court holds the taxpayer had not proved the stock was worthless in 1945; the deficiency judgment was not entered in that year and its amount was not yet certain. *875 Park Ave. Co.* v. *Comm'r.*, CA-2, 12/6/54.

Bad debt not allowable merely on showing of book deficit. Taxpayers claimed a bad debt loss on advances to their wholly-owned corporation as evidenced by its balance sheet showing an excess of liabilities over assets. The Court held that without evidence of the market value of the assets, there was no proof of worthlessness. *Ann Greene*, TCM 1954-193.

Sale of easement may mean involuntary conversion. Where under threat of condemnation taxpayer granted the government a perpetual easement of air rights which deprived him of almost all beneficial interest in the land excepting retention of legal title, the sale was considered an involuntary conversion subject to relief provisions. The consideration received therefor may be used to reduce the basis of such land and any excess of the payment over the basis is capital gain. *Rev. Rul.* 54-575.

Farm with rental house is "similar" to farm with residence and rented house. For purposes of the 1939 Code § 112(f)(3) the involuntary sale on threat of condemnation of farm with single rental residence and purchase of farm with two rental residences is a replacement of property "similar or related in service or use" and taxpayer's contemplated use of one residence as a home will not prejudice his election to defer recognition of the gain involved. *Rev. Rul.* 54-569.

Accrual method used except for inventories—correction not barred by acceptance of prior returns. Taxpayer kept the records for his business of buying and rebuilding motor blocks on an accrual basis, but omitted inventories of these blocks. He took complete inventories but entered only those of new parts. The Court approved the Commissioner's action in including the block inventories; it properly reflects income and moreover is clearly required by the regulations. The Commissioner is not estopped by his acceptance of the erroneous method in prior years' returns. *Harry Hartley*, 23 TC No. 42.

Microfilming old newspaper files was expense, not capital cost. Following a bomb scare in 1942, a newspaper publisher decided to microfilm at a cost of $40,000 its old papers of which it had only one or two bound copies. The Commissioner asserted that the cost should be amortized over 25 years. The Court holds that this microfilm record was in no way an improvement over the bound volumes which are easier to handle and for which there was plenty of room. There was no improvement or increase in value. The cost was merely an expense of current operation. *Times Mirror Co.* v. *US.*, DC Calif., 7/29/54.

Stockholder's advances become capital when he voluntarily releases claim. Taxpayer was a large stockholder in, and operated, a corporation manufacturing overhead garage doors. He guaranteed many of its loans. In 1949, he paid $^1/_3$ of some guaranteed debts and gave his notes for the other $^2/_3$. In 1950 he claimed the payment of these notes as a bad debt. However, in 1950 he decided to change the business to box manufacturing and, to get a new manager, released his claims against the corporation. The Tax Court had disallowed the bad debt deduction on the ground that the corporation had been insolvent from the end of 1948, the debts had no value when they arose on payment under the guaranty, and therefore did not "become" worthless in 1950. The case is remanded to the Tax Court to determine whether any claims were not released; if not released, they should be allowed as bad debts. The rest are contributions to capital. *Bratton* v. *Comm'r.*, CA-6, 12/10/54.

Disputed taxes not deductible in final year of corporation. The Tax Court refuses to accept taxpayer's argument that it should be permitted, in its final year, to deduct taxes not yet accrued because it was contesting its liability. The Court points out that the corporation continues in existence to wind up its affairs, and the deduction will be available to the trustees in dissolution. *Bryant Heater Co.*, TCM 1954-201.

Interest on overpayment, offset against assessment, runs to assessment date. A reduction in taxpayer's excess profits tax, through unused credit carryback, resulted in an increase of its income tax for the same year. By consenting to immediate assessment after deficiency notice (March 1946) interest stopped accruing to the government 30 days after the consent (April 1946) although the deficiency was not assessed until June 1947. The refund owing taxpayer was applied against the total deficiency. The court held that the taxpayer was entitled to interest on the refund owing him until June 1947. *Virginia Electric & Power Co.* v. *U.S.*, Ct. Cls., 11/30/54.

Cemetery receipts for perpetual care not income. Taxpayer, a cemetery corporation on the accrual basis, is required by the terms of its sales contracts to set aside 30% of the purchase price of cemetery plots in a trust fund for the perpetual care and maintenance of the cemetery. The court held that the taxpayer may properly exclude the

New Decision on Capital Gains Tax This Month

Ordinary income realized on lot sales despite desire to liquidate. Taxpayers subdivided, improved, and sold land on contracts in 1920's but lost their land to the state for nonpayment of property taxes when the purchasers defaulted on contracts during the depression. Subsequent repurchase from the state and sale after further improvements held to result in ordinary income and not capital gain despite desire on part of taxpayers to liquidate. Rental of real estate office allowed as a deductible business expense. *Estate of Wilson Critzer*, TCM 1954-211.

Gain on covenant not to compete is capital. [Acquiescence.] Taxpayer sold stock in newspaper corporation for nearly $400,000. Included in the contract was a covenant not to compete in the area for ten years. A subsequent contract assigned $100,000 to that covenant on the buyer's urging that this would permit him to depreciate the $100,000. The Court finds that the covenant was merely incidental to the sale and had no true separate value. The entire proceeds are for the sale of the stock and none represents ordinary income allocable to the covenant. *George H. Payne*, 22 TC No. 66., *Acq. IRB.* 1954-47,5.

Sale of discount notes 10 days before maturity results in ordinary income. Taxpayers sold noninterest-bearing notes 10 days before maturity. They realized an amount equal to the face value of the notes (substantially more than the value at the date of issue) less 3% discount. This amount was held to represent interest in the form of a discount taxable as ordinary income and not capital gain. *F. Rodney Paine*, 23 TC No. 48.

Widow taxed on crop proceeds even though not sold by deceased husband. [Cert. denied.] The decedent, a farmer, delivered grapes to a cooperative marketing association. Taxpayer, his widow, received proceeds from the cooperative representing her husband's share of sales proceeds realized after his death. The Ninth Circuit noted that the proceeds would have been taxable as ordinary income to the husband had he lived. Sec. 126 of the 1939 Code was enacted to prevent loss of tax in such cases in consequence of death. The proceeds were thus held taxable to the wife. However, payments to decedent's estate (distributed to taxpayer) representing his equitable interest in the grapes and grape products held by the cooperative, represented capital gain and not Sec. 126 income. *Linde* v. *Comm'r.*, CA-9, 213 F. 2d 1, *Cert. denied* 11/8/54.

Alternative tax on capital gains not reduced by excess of deductions over ordinary income. Taxpayer's deductions exceeded his ordinary income (without capital gain) for the year 1948. However, he also had a capital gain of about $1.5 million. In computing his tax, the alternative tax (50% of 50% of the long term gain) is not affected by the unused deductions. The Court notes that his is a case of first impression, it reviews the history of capital gains taxation and finds the Code clear that the alternative tax is computed on gross capital gains. *Walter M. Weil*, 23 TC No. 51.

30% (impressed with a trust) from its gross income. *Twin Hills Memorial Park and Mausoleum Corp.*, TCM 1954-206.

Contract for deferred payments not income to taxpayer on cash basis. Taxpayers, on the cash basis, sold lots for cash down payment and purchaser's contractual obligation to pay balance in the future. They received ordinary income only to the extent that the cash payment exceeded the basis of the property sold, the contracts not being the equivalent of cash. *Estate of Wilson Critzer*, TCM 1954-211.

Surrender of bridge to city for extended franchise was taxable exchange. Taxpayer operated an amusement park and had a franchise to operate a street railway to its park over a bridge built and maintained by it. Financially unable to repair this bridge, taxpayer in 1934 gave it to the city in exchange for a 10-year extension of its franchise. It wrote off the unrecovered cost of the bridge on its books without reporting any gain or loss on the exchange or adding the undepreciated cost or fair market value of the bridge to the cost of the franchise. In 1946 taxpayer abandoned its franchise and claimed a net loss including the unrecovered cost of the bridge. The court held that the exchange in 1934 was taxable and taxpayer was entitled to use as the cost basis of the franchise extension the fair market value of the bridge at the time of exchange. *Philadelphia Park Amusement Co.* v. *U.S.*, Ct. Cl., 11/30/54.

Husband's 10-year legal fee received in joint return year can be carried to wife's separate returns. Taxpayer-husband, as a member of a law firm, received in 1950 a share of partnership income representing a fee earned over ten years. In 1950, the taxpayer and his wife filed a joint return, but in several of the ten preceding years they filed separate returns. The Court holds that the tax for 1950 should be computed as though half had been reported by the wife in each of the ten years, including those in which she filed separate returns. *Koontz* v. *U.S.*, DC S.Va., 11/5/54.

Punitive damages in anti-trust action are taxable. Taxpayer collected $1 million in settlement of treble damages claimed from Hartford-Empire Co. for anti-trust law violation. The court held that only $^1/_3$, the actual damages, was taxable. Conceding that punitive damages are not "gain derived from capital or labor," the court considers that definition (from *Eisner* v. *Macomber*, 252 U.S. 189) is not all inclusive, and that the Tax Court's rationale was therefore in error. This court follows the Second Circuit on the "insider profit" cases (*Glenshaw Glass* and *Goldman Theatres* (211F 2d 928)), which held corporations taxable on profits on security transactions of insiders paid over to them under the Securities and Exchange Act. It sees no difference between insider profits and punitive damages. *Obear-Nester Glass Co., Comm'r.* v., CA-7, 11/15/54.

Must allow cost of cattle in year sold despite deduction in year bought. *[Acquiescence.]* Taxpayer, a cattle feeder, had, as a "farmer," elected the cash basis. The Court held he was not allowed to deduct in 1945 and 1946 the cost of cattle purchased in those years but not sold. However, the Tax Court required the Commissioner to allow the cost of cattle sold in those years, but purchased prior, despite the fact that the taxpayer had deducted that cost in the year of purchase. *D. E. Alexander*, 22 TC 234., *Acq. IRB* 1954-47, 5.

Depreciation allowed from the time court decreed right to possession of property. *[Acquiescence.]* A state court decreed in 1942 that mortgagees must reconvey title to property in their possession to mortgagor-taxpayer. Mortgagees held title until the accounting proceedings ended in 1947. Taxpayer was entitled to take depreciation allowance for period from 1942 to 1947 since he was the equitable owner even though he had neither title to nor possession of the property. The taxpayer was also permitted to deduct legal expenses attributable to the accounting proceedings; legal expenses attributable to the title determination had to be capitalized. *E. J. Murray*, 21 TC 1049, Acq., IRB 1954-49,6.

Insurance proceeds realized after settlement of embezzlement claim not within tax benefit rule. In partial repayment of funds embezzled from taxpayer-company, one of its officers transferred to it life insurance policies (face value: $65,000; net equity at that time: $455). The taxpayer deducted the allocable portions of its net embezzlement lost of $229,979 on its returns for the years in which the embezzlements had occurred but realized a tax benefit of only $66,326. Taxpayer then repaid the loans on the insurance policies and paid premiums up to the date of the former officer's death in 1948. The Commissioner contended that the insurance proceeds over and above the net equity at the time of assignment, the loans repaid and premiums paid constituted taxable income of $22,500. The court ruled that the tax benefit rule could be invoked only where there was a recovery directly attributable to a previous loss which produced no income tax benefit. The insurance investment followed a settlement with the defaulting officer (receipt of the insurance helped to extinguish the obligation and was not mere collateral for its repayment) and was a new transaction separate from the embezzlement loss. *Waynesboro Knitting Co.*, 23 TC No. 49.

Date of accrual of real estate tax. The date on which Oklahoma taxes on real and personal property become due and payable by the owner of property (Oct. 1) is the date on which they accrue for federal income tax purposes. [Under the 1954 Code an accrual-basis taxpayer may deduct real estate taxes ratably over the period to which they apply. Ed.] *Rev Rul.* 54-564.

Cost of defending title suit is capital. The executor of the estate of the taxpayer's wife sued the taxpayer on the ground that certain property (money and stock in a corporation the taxpayer operated) was either community or her separate property. Taxpayer won. The Ninth Circuit agrees with the Tax Court that the fees paid to accountants and attorneys were in defense of ownership and title and not deductible. *Shipp* v. *Comm'r.*, CA-9, 12/2/54.

Buyer's assumption of tax on business income makes both buyer and seller liable. A married couple failed to pay taxes on income earned from a cafe they operated. Husband transferred his interest in the cafe to his wife who later sold it on condition that the purchaser assume the tax liability of the seller and her husband. The court held that the husband and wife remained liable and that the purchasers were jointly liable for the taxes also. *Nevatt, U.S.* v., DC Cal., 11/24/54.

Another stock option plan fails; option-market spread is income

HERE IS SOME COMPANY for Charles E. Sorenson, the Willys Motors ex-president whose stock option plan failed (JTAX, July 54, p. 15), in the person of one Harold A. MacDonald. As in the case of Mr. Sorenson's sad tale, the Tax Court says Mr. MacDonald's spread between option price and value at date of purchase is ordinary income.

Mr. MacDonald was employed as a vice-president and director of Schenley Distillers, Inc., from 1944 to 1948. In May 1947, he was induced to explore the presumably greener pastures of Household Finance Corporation, which was looking for a president. When the negotiations got down to money, MacDonald disclosed that he had been working for a basic compensation of $50,000 to $70,000, plus substantial distributions from an executive bonus plan, plus certain deferred compensation benefits, plus participation in a retirement plan. He was careful to point out that as the deferred compensation credits and accrued benefits under the pension plan would be forfeited if he left Schenley, he naturally wanted something to take their place. He thought a stock acquisition plan might be interesting.

After many months of negotiations, in May 1948, a letter agreement was signed. It provided that, as an inducement to MacDonald's acceptance of employment as an executive, Household Finance Corporation would sell him up to 10,000 shares of its stock at some price between market value at the time of purchase and the adjusted book value on May 31, 1948. It also agreed to lend him the full purchase price and also (perhaps with premonition of doom) the amount of any income taxes for which he might become liable by reason of the purchase. The price and number of shares to be acquired within the limits set forth were to be mutually agreed upon or, in the absence of agreement, were to be fixed by named arbiters. In the event of a purchase MacDonald was required to give a non-interest bearing note to be secured by the purchased stock. The note was payable in installments consisting of all the dividends paid on the stock (after MacDonald's taxes thereon) except that at the end of 15 years the entire balance was payable. This letter was confirmed by a formal three year employment contract.

In October 1949, MacDonald exercised his option to buy the full 10,000 shares at $18.70 a share, the figure which had been agreed upon. The market value at that time was $33.75; at the time of the letter agreement it had been $30.87.

The Commissioner claimed a tax on the spread at the time of purchase, on the theory that such spread was compensation. MacDonald's answer was that the option was granted as an inducement to accept employment, and that it was therefore a "proprietary" option.

The Tax Court decided the factual issue in favor of the Commissioner. Said Judge Rice:

"After careful consideration of the entire record in the instant case, with particular attention to the various negotiations which culminated in the option agreement and employment contract granted to petitioner, to the correspondence between petitioner and the then president of the company, and to the various statements issued by the company regarding petitioner's employment and the stock option granted to him, we have concluded that the option price was determined with the intent that it compensate petitioner. We recognize that there may have been a fixed intent that petitioner acquire and hold his stock as a permanent investment in the corporation. Nevertheless, we think it clear that the option price was established with the intent that he acquire such stock at a price substantially lower than its market price as a reward for services to be rendered."

MacDonald's alternative argument that the stock had no value in the year of purchase because he could not sell it during his employment was dismissed by the court with the comment that there was no proof of any binding agreement not to sell.

Why did MacDonald lose when LoBue (JTAX, Sept. 54, pp. 51–2) won? Perhaps the most important single difference is that LoBue's option price was slightly *more* than market value at the time of grant. Whether that factor alone is enough to insulate an option from treatment as compensatory is doubtful.

Note that MacDonald would not have benefited appreciably from arguing that his option was of the McNamara category (JTAX, June 54, pp. 42–3) because the spread at the time of grant was only slightly less than the spread at the time of exercise. ☆

New decisions

Payment of more than required 5% of profit follows plan; directors had amendment power. Taxpayer's profit-sharing plan provided for payment to the fund of 5% of net profit but not more than 15% of compensation. However, it also provided that the directors could amend the formula. The court holds the directors' action in contributing more than 5% was an informal amendment of the plan. Consequently, the contributions are in accord with the plan and deductible. *The McClintock-Trunkey Co.* v. *Comm'r.*, CA-9, 12/7/54.

$5,000 exclusion applies to excess of death benefits over retirement payment. A qualified plan provided for lump-sum payments upon death, retirement or termination of services. The death or retirement payments were larger because employer contributions for two years prior to voluntary severance would not be paid. The IRS holds that the excess of death benefits is payable solely because of the employee's death and may be excluded from gross income up to $5,000. *Rev. Rul.* 54-531.

TAXATION OF

Partnerships

EDITED BY ROBERT M. MUSSELMAN, LL.B., CPA

Medical group taxed as a corporation, thus permitting doctors tax-free pensions

CASES INVOLVING ORGANIZATIONS which are partnerships under local law but which are treated as "associations taxable as corporations" for tax purposes have not been plentiful. This month we have a significant case in this area, where the usual position of the parties in such a controversy was reversed, in that the taxpayer was insisting that the organization should be treated as a corporation and the government was arguing that it should not. The case was *U.S.* v. *Kintner,* decided by the Court of Appeals for the 9th Circuit on October 14, 1954, affirming a decision of the District Court for the District of Montana which was reported at 107 F. Supp. 976.

Significance of findings

The first significance of the case lies in its concern with an actual "association," rather than with the new sort of entity created by the 1954 Code, a partnership electing to be taxed as a corporation. Further, the Court found in this case that the members of the group were in fact entitled not only to escape tax on undistributed profits of the business but, more important still, were entitled to participate as employees in a qualified pension plan.

This last finding is of particularly broad significance because of the denial of this opportunity to those partnerships electing to be taxed as a corporation under the new Code provision. Further, it is interesting to note that the business here in question was group practice of medicine, so that the lessons of the case are especially important to all those partnerships which, because of local law, are prevented from becoming corporations.

For many years prior to June 30, 1948, the taxpayer practiced medicine in the State of Montana as a member of a partnership. On that date, the partnership dissolved and "Articles of Association" were executed. Assets and liabilities of the partnership were taken over by the Association which continued to carry on the partnership activities. All but two employees of the partnership became employees of the Association.

The Articles provided that the members "associate themselves together for the practice of medicine and surgery as an unincorporated association," which was to be endowed with the "attributes of a corporation" and to be "treated as a corporation for the purposes of taxation." The Association was to terminate upon the death of the last survivor of the original members, who were the eight doctors who had been the members of the prior partnership, and only physicians and surgeons duly licensed to practice in Montana were eligible for membership.

The business of the Association was to be managed by an Executive Committee composed of five of the members, who were to select officers. Any indebtedness incurred by the association through the act of a member without authorization by the Committee was chargeable against such member's share of the earnings of the Association. Only the members, rather than the Association, were liable to third parties for professional misconduct. The members were to receive "salaries fixed by the Executive Committee." The net earnings of the Association were to be divided among them "in proportion to the salaries of such members," and "all sums paid to members . . . by way of distribution of net earnings shall be deemed to constitute compensation to the members of the association for services rendered by them during the year."

The Association was to collect the "accounts receivable for professional services rendered" by the members, was to furnish them with the equipment needed to render such services, and was to pay "all necessary expenses incident to the practice of medicine and surgery by its members." Instead of receiving an interest in the assets of the Association, each member agreed that, upon his death or withdrawal, he would accept the benefits of a pension plan, the cost of which was to be borne by the Association. Death or retirement of a member was not to result in dissolution of the Association and the interest of a member was "non-assignable."

Since its formation, the Association had operated in accordance with its articles; powers of management were in the Executive Committee and its appointed officers. The Association rented space for use in the practice of medicine, employed services of non-member doctors and other employees; collected the fees earned for medical services rendered by its members and other doctors employed by it; paid them salaries and expenses incurred in practicing their profession; and it also paid social security and withholding taxes, for which purposes it included among its employees the member-doctors. It paid federal corporation income taxes and state corporation license taxes.

Articles provided pension plan

The Articles provided for the establishment of a pension plan for the benefit of "qualified employees," whereby those who had been employed by the Association or the predecessor partnership for at least three years and had attained at least the age of thirty became entitled to pension benefits upon retirement. Upon its formation the Association entered into a pension fund agreement with a trustee bank. All contributions were made by the Association and not by the participants. Included among the "employees" were the member-doctors of the prior partnership, and in computing the length of service for all the "employees," credit was allowed for that period during which their services were rendered for the predecessor partnership.

During 1948 the Association set up a "reserve" fund to cover future operating expenses and also made the required contributions to the pension

fund. The taxpayer, a member-doctor, reported neither of these items on his return for 1948; the Commissioner added the portion attributable to the taxpayer as if the Association was a partnership and assessed a deficiency against him. The taxpayer paid and filed claim for refund.

On the above facts, the court concluded that the business form here involved had more of the attributes of an association than it did a partnership, and that it would consequently be taxable as a corporation. Support for this holding was found in Regulations 111, §§ 29.3797-2 (defining the scope of the term "association") and 29.3797-4 (referring to continuity of interest and centralized management as criteria indicating an association taxable as a corporation). The contention of the government that such a holding was precluded by local law which prohibited the practice of medicine by corporations was summarily dismissed as an attempt to "introduce an element of uncertainty which neither the courts nor the regulations have recognized." The court continued:

> . . . It would introduce an anarchic element in the federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that the tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence.

Notwithstanding the concession by the taxpayer that the Association was probably a partnership under Montana Law, the court, after concluding that its business form was that of an association taxable as a corporation for tax purposes, passed upon the validity of the pension plan. The additional findings of fact were: that the plan was for the exclusive benefit of the employees; that neither the pension committee nor the trustee had the power to divert or liquidate the trust; that the rights of the employees in the annuity contracts were non-transferable and non-assignable, and that there was no power in the Association to deprive a participant of his right to receive the benefits of the plan. In holding that the pension plan qualified under the 1939 Code, the court extended the usual definition of "employees" to include the member-doctors.

State law doesn't control

The finding that the business form employed here was an association taxable as a corporation under the Internal Revenue Code, in spite of the local statutory prohibition of the practice of medicine by corporations, can hardly be deemed a change in decided law. It has long been recognized that Congress has the power to tax as a corporation any association which transacts its business as if it were incorporated, notwithstanding the status of the business form under local law. *E.g.*, *Burk-Waggoner Oil Association* v. *Hopkins*, 269 U.S. 110 (1925), T.D. 3790, 1926-1 CB 147. For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classifications. Local law is of no importance in this connection. Regulations 118, § 39.3797-1.

The determination of the taxable form of the organization is for the purposes of the Code and not for any specific section thereof. With this premise in mind, we concur, for the most part, with the decision in the instant case. If the organization is determined to be a corporation, for tax purposes, its status as a partnership under local law should have no significance for tax purposes. The partners become holders of proprietary interests and occupy a position in the nature of stockholders. Of course, they can also be employees. The taxability of the income earned by the corporation is computed with reference only to that taxable entity. The treatment accorded the income of the owner-employee should be the same treatment accorded any other stockholder-employee under the Code.

If the organization here involved had been a corporation under state law, there would have been no question, under the given facts, of the taxability to the stockholders of the undistributed "reserve" or of the validity of the pension plan. The reserve was not distributed, and the stockholder-employees would be eligible under the pension plan. Regulations 111, § 29.165-1 (g). To hold the members to be partners and employers, and, as such, not eligible to participate in the plan would seem to discredit the previous finding that the organization was not a partnership but an association taxable as a corporation.

To the extent outlined above, we feel that the instant case is correct and that the holding would be the same under the 1954 Code. We do not feel that this is the sort of factual situation contemplated by Internal Revenue Code 1954, Section 1361(d), for this is not an *election* by a partnership to be taxed as a corporation; this is a *finding of fact* that the form of organization *is* a corporation, as defined in the tax law.

One questionable element

There is, in the instant holding, one questionable aspect. The members of the Association were given credit for their "employment" in the predecessor partnership in determining their eligibility under the retirement plan. It has been the Commissioner's position that such an allowance of credit would defeat the plan of a regular corporation, Rev. Rul. 33, Part 2(b)(1). Here the court felt that such a provision would not serve to discriminate in favor of the member-doctors, but, rather, it would prevent discrimination against them. The purpose of the pension plan was to encourage long tenure. The employees of the prior partnership were to be given credit for their service thereunder, and the employees of the Association were to be given credit for their service for the Association. Such a provision merely placed the member-doctors on an even standing with the partnership employees who continued in service with the Association, and the entire group of partnership "employees" were preferred over late-comers. The court considered the object of the plan was to achieve equality, and that the plan could not be disqualified as discriminatory. Under the peculiar facts of this case we agree with the holding herein, but the implications of this part of the holding we deem questionable for future tax planning. ☆

How well do you know your partnership tax rules?

HERE ARE SOME QUESTIONS to test your familiarity with the new partnership tax rules under the 1954 Code, prepared by William H. Westphal, CPA, a partner of A. M. Pullen & Co., Greensboro, N. C. Answers below.

1. What is the rule concerning the tax-

able year that may be adopted by a partnership?

2. When does the taxable year of a partnership change?

3. (a) What is the basis for loss or gain of property transferred by partners to a partnership?
(b) Is loss or gain recognized on such a transfer?

4. Describe the manner in which the items comprising a partnership's income are picked up on the returns of the partners.

5. Is the gain on the sale of a partnership interest to be treated as a capital gain or as ordinary income? (Assume the partnership's possession of accounts receivable and an inventory.)

6. (a) A partner owning a $^2/_3$ interest in the ABC partnership sells to the partnership for $75,000 depreciable property having an income tax basis to him of $100,000. What is the proper treatment of the loss?
(b) What is the basis of the property for loss or gain in the hands of the ABC partnership?

7. Explain the manner of determining the basis of depreciable property received in liquidation of a partnership interest, assuming that cash was also received in liquidation.

8. What is the general rule concerning the effect of a sale of a partnership interest upon the basis of partnership property?

Answers

1. A partnership may not change to or adopt a taxable year other than that of its principal partners. A principal partner is one having an interest of 5% or more in the partnership profits or capital.

2. A taxable year of a partnership remains the same until it is terminated.

3. (a) The basis for loss or gain of property transferred by partners to a partnership is the same as the basis in the hands of the partners.
(b) No gain or loss is recognized on the transfer to the partnership.

4. Each partner shall take into account separately his distributive share of the partnership's income broken into its separate classifications, such as gains or losses on sale of capital assets, charitable contributions, dividends, exempt interest, etc.

5. The gain on the sale of a partnership interest is capital gain except to the extent that it is applicable to unrealized accounts receivable and appreciated inventory. To the extent that it applies to these receivables and inventory, it is ordinary income.

6. (a) The loss is unallowable.
(b) The basis is $75,000; however, in the event of sale at a profit, the $25,000 disallowed will be used to reduce the gain.

7. The partnership capital account is first reduced by the amount of cash received. The general rule requires that the partnership property taken over by the partner shall retain the partnership basis. However, if the basis of the partner's interest after application of the cash thereto is lower than this partnership basis in the property, the remainder of the partner's capital account is allocated to the partnership property distributed, using the ratio of the partnership basis in each piece of property to the partnership basis in all property thus distributed.

8. Under the general rule the basis of partnership property does not change as a result of the sale of a partnership interest.

New partnership decisions this month

Wife recognized as partner. ***[Aquiescence.]*** The court found a business purpose (improving borrowing power in liquidation of a department store corporation and creation of a partnership. Taxpayer gave his wife a one-tenth interest in the partnership. In view of her experience in the field, the court found a real intent for them to carry on the business as partners. *Fred M. Harvey,* 21 TC 1020., *Acq. IRB* 1954-47,5.

Wife held partner; she made half of gift to son. Husband and wife operated a poultry farm together during all their married life. In 1949 their son was admitted as a partner and the husband and wife each reported $^1/_2$ the value of the son's third as a gift. The Commissioner objected, stating that the husband made two gifts giving a third to his wife and another third to his son. The court held that the wife was a bona fide partner in the business: she invested money in the business at its inception and made further capital contributions from time to time, and devoted her full time to business tasks. The gift to the son was made by both parents. *E. P. Grimes,* TCM 1954-219.

Wife is partner in department store. The Commissioner erred in refusing to recognize as valid a partnership between the taxpayer and his wife. The wife contributed a substantial amount of capital to the business, joined in guaranteeing notes, and rendered services in the purchasing and sales departments for which she did not receive salary. *Newton V. Prince,* TCM 1954-214.

Though tax saving was principal motive, tax court erred in finding partnership a sham. The Tax Court's "finding of fact" that the partnership was a sham is really a determination of the issue and not binding on the Circuit Court. The Fifth Circuit reverses the Tax Court and holds the evidence overwhelming that the parties did intend to carry on business as a partnership. *The Friedlander Corp.* v. *Comm'r.,* CA-5, 11/16/54.

Incorporation of partnership taxable; proportionality of interest not shown. The Court sustains the Commissioner in finding that the issuance of stock in a new corporation to members of a family partnership in exchange for their interests in the partnership was taxable. The taxpayer did not show that his interest in the new corporation was substantially equivalent to his interest in the assets of the partnership as would be required in a tax-free exchange. *Albert Dick Guggenheim,* TCM 1954-183.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH S. MARTEL

Heaviest taxing states revealed by comparative analysis of revenue sources

STATE AND LOCAL GOVERNMENTS collected $30.5 billion in revenue in fiscal year 1953. From studies just released by the U. S. Bureau of the Census it is now possible to discover which states imposed the heaviest tax burden, and which taxes were used most in which states.

In addition to the $30.5 billion in revenue from state and local sources in 1953, the federal government made an additional $2.9 billion (not including loans) available for state and local spending through grants-in-aid, shared revenue, distributions and payments for state or local services. Altogether, therefore, the state and local levels of government received $33.4 billion in revenue (excluding amounts from other state or local governments) in 1953. The state governments accounted for $17.8 billion and local governments for $15.6 billion of the total amount.

The data in these reports relate to governmental fiscal years ended during calendar year 1953. For most governmental units this means the twelve months ending June 30, 1953.

These proportions do not take account of the redistribution of revenues through subsequent state-to-local and local-to-state transfers. In terms of amounts finally available for spending, the state portion dropped to $12.6 billion of the total and the local portion rose to $20.8 billion.

In aggregating revenue amounts for groups of governments, transfers between the governments involved are eliminated just as internal transfers are eliminated in consolidating transactions of individual governments. For example, a local government total of revenue will exclude local-to-local transfers, but may include local government revenue from the state and federal governments. A state and local revenue aggregate will exclude state-to-local, local-to-state, and local-to-local transfers but will include state and local government revenues from the federal government. Table I shows state and local government revenue by sources.

It will thus be seen that of the $30.5 billion revenue from state and local sources in 1953, about $^2/_3$ or $20.9 billion was derived from taxes, $3.5 billion came from non-tax general revenue, $2.2 billion was collected for local government utility services (water, electric, transit, and gas), $1.1 billion was revenue of liquor stores and $2.8 billion represented earnings of, and contributions to, unemployment compensation, employee retirement, and other insurance-trust funds.

There is great variation from state to state as to state and local government reliance on different revenue sources. For the nation as a whole, property taxes provided about $^1/_3$ of state and local general revenue, the proportions ranged from 12.5% in New Mexico and 15.7% in Alabama to 55.8% in New Jersey. Similarly, the use of general sales and gross receipts taxes ranged from zero in 12 states to 27.8% in West Virginia.

State and local governments do not themselves raise all the revenue available to them for final expenditure, nor do they spend directly all the revenue they collect. Thus, in 1953, while the state governments collected from the public $11.8 billion in taxes and other general revenue, there was available to them an additional $2.6 billion from the federal government and $0.2 billion from local governments. However, they distributed $5.4 billion to their local governments leaving $9.1 billion of general revenue available to the states for their own purposes. Similarly, local governments collected $12.7 billion of general revenue from their own sources, but after receiving grants, shared taxes, and reimbursements from state and federal governments, and paying a small amount to the states (largely reimbursements for services) they had $18.2 billion in general revenue available for direct spending. Percentagewise, state and local government general revenue was distributed by originating governmental level as follows:

10.5%	from federal sources
43.0%	from state sources
46.5%	from local sources
100 %	

By final recipient level, the total was distributed:

33.4%	for state purposes
66.6%	for local purposes
100 %	

From the information in these reports we can conclude the major sources

TABLE I—STATE AND LOCAL REVENUE BY SOURCES
(In billions of dollars)

	All state and local units	*State*	*County*	*City*	*Township*	*School dist.*	*Special dist.*
Property taxes	9,375	365	1,954	3,375	566	2,910	205
Individual income	1,065	969	—	93	—	3	—
Corporation income	817	810	—	7	—	—	—
Sales and gross receipts	6,927	6,209	25	685	7	1	—
All other taxes	2,723	2,200	72	392	19	40	—
Charges and misc.	3,529	1,198	451	1,063	51	354	413
Utility and liquor store rev.	3,323	967	70	1,864	32	—	390
Insurance-trust revenue	2,781	2,501	27	223	1	24	6
	$30,540	15,219	2,599	1,702	676	3,332	1,014

of *state tax revenue*. Of course, local revenue would materially alter this picture. The major source of *state* tax revenue by states is shown in Table II.

Surprising as it may seem, there are 13 states where the major source of state tax revenue is the gasoline tax and there are two states, Louisiana and Texas, where the major source is severance tax and one state, namely, New Jersey, where the major source (22%) is motor vehicle license.

Your Editor believes that within the next few years this picture will materially change as the remaining states will resort either to sales and use taxes or to income taxes or both. ☆

TABLE II—MAJOR SOURCES OF STATE TAX REVENUE

(In % of total revenue attributed to each category)

	Sales use, etc.	*Gasoline*	*Income*
Alabama	38	—	—
Arizona	32	—	—
Arkansas	—	27	—
California	37	—	—
Colorado	30	—	—
Connecticut	33	—	—
Delaware	—	—	26
Florida	—	28	—
Georgia	46	—	—
Idaho	—	31	—
Illinois	38	—	—
Indiana	49	—	—
Iowa	33	—	—
Kansas	34	—	—
Kentucky	—	33	—
Louisiana*	—	—	—
Maine	—	29	—
Maryland	—	—	23
Massachusetts	—	—	30
Michigan	47	—	—
Minnesota	—	—	26
Mississippi	—	30	—
Missouri	40	—	—
Montana	—	33	—
Nebraska	—	44	—
Nevada	—	33	—
New Hampshire	—	27	—
New Jersey†	—	—	—
New Mexico	37	—	—
New York	—	—	49
North Carolina	—	—	27
North Dakota	30	—	—
Ohio	35	—	—
Oklahoma	—	23	—
Oregon	—	—	44
Pennsylvania	—	21	—
Rhode Island	25	—	—
South Carolina	29	—	—
South Dakota	30	—	—
Tennessee	—	30	—
Texas‡	—	—	—
Utah	31	—	—
Vermont	—	—	26
Virginia	—	—	31
Washington	51	—	—
West Virginia	52	—	—
Wisconsin	—	—	45
Wyoming	30	—	—

* Louisiana: 23% from Severance.
† New Jersey: 22% from Motor Vehicle License.
‡ Texas: 32% from Severance.

Industry & professional groups are attacking problem of uniform state taxation

by PAUL A. RECK, assistant treasurer, Sperry Gyroscope Company

ALTHOUGH LITTLE LEGISLATIVE progress has been made recently in achieving uniformity of state taxation, several industrial and professional groups are working hard on this problem. As a result of the growing awareness of the need to eliminate the vast differences in taxing method, the Conference of Governors considered this problem for the first time at its meeting at Bolton Landing, New York.

It is well recognized that state income tax statutes have generally been enacted by individual states with the primary view of raising revenue. Little concern has been given to the final effect of such tax legislation with the result that tax measures have been adopted which have resulted in discrimination and inequities.

Nightmare for corporate taxpayer

Today, the inconsistencies and overlapping provisions of the various state tax structures have become a nightmare for the corporate taxpayer faced with the task of complying with multiple tax laws and regulations. Businesses are now harassed with costly administrative burdens and clerical tasks involved in accumulating data in the preparation and filing of numerous tax returns with the different states, no two of which are alike. Of even greater importance is the fact that, as state and local governments have reached out and imposed taxes on interstate commerce, an increasing number of companies have been put in the position of being taxed on the same income by two or more states, thereby causing increased tax burdens which corporations are compelled to carry. The states themselves have also suffered from this lack of uniformity in the considerable administrative costs involved in the collection of necessary taxes and in the enforcement of tax laws.

As a result there has developed considerable pressure, both from corporations as taxpayers and from the states as tax collectors, to develop some uniform method of assessing taxes on corporations doing business in more than one state.

Administrator's efforts help

From time to time the problems of uniformity among state corporate tax laws have been studied and recommendations made for statutory changes to alleviate existing difficulties. The National Association of Tax Administrators in 1948 and the National Tax Association in 1950 released the results of their studies and recommendations. More recently the National Conference of Commissioners on Uniform State Laws established a special committee to investigate the problem. At the 46th Annual Meeting in 1953, the Governors' Conference requested the Council of State Governments to prepare recommendations on means for attaining uniformity in corporate state income taxation of businesses engaged in multistate operations.

Controller's studies are latest

Meanwhile, study of the subject was also undertaken by the National Committee on State and Local Taxation of the Controllers Institute of America. In 1953, this committee requested the Controllership Foundation, the research arm of the Controllers Institute, to make a comprehensive examination of current state tax laws on taxation of corporate income. The study was directed by Herbert F. Klingman, research director of the Foundation and a panel of Institute members, and conducted by the University of Michigan, Bureau of Business Research.

The results of this study, written by Albert H. Cohen, CPA, were published in April 1954 by the Controllership Foundation in its report entitled "Apportionment and Allocation Formulae and Factors Used by States in Levying Taxes Based on or Measured by Net Income of Manufacturing, Distributive and Extractive Corporations."[1] The report is thorough in its analysis of diffi-

[1] May be purchased at Controllership Foundation, 1 East 42nd Street, New York City, at a cost of $1.50.

culties and inequities currently experienced and contributes much toward attaining an intelligent understanding of the inconsistencies of the present tax structure and the results to which these inconsistencies lead. The report contains no recommendations.

Subsequently, the Institute's National Committee on State and Local Taxation developed its findings and recommendations. In June of this year these were submitted to the Council of State Governments together with the Controllership Foundation research report. This material has been of valuable assistance to the Council's committee of tax administrators in studying and preparing its recommendations.

Recommendations to governors

At the Governors' Conference held this summer, the Council's report was submitted together with copies of the Controllership Foundation research report and recommendations of the National Committee on State and Local Taxation. In general, recommendations of both groups included the following points:

1. Uniformity of apportionment formulae among corporate tax laws of the various states is highly desirable, and its wide adoption would be beneficial to the states and the taxpayers.

2. Benefits of uniformity to the states would be increased by legislation empowering tax administrators to exchange tax information with officials in other states.

3. Identification and allocation of specific items of non-business income should be held to a minimum and should be restricted to items unrelated to the taxpayer's major business activities.

4. The three-factor formula of sales, payrolls, and tangible property constitutes a fair and equitable basis for taxation and should be adopted by all states.

5. Uniform definitions of each of the factors in the formula should be adopted in all states.

The Council of State Governments, in cooperation with state tax administrators and corporate taxpayers, is now in process of evaluating the financial impact of uniform definitions on the revenues of individual states before coming up with recommendations.

Leaders are well-known tax men

Some of the early pioneers who were responsible for initiating the drive for state tax uniformity include Joseph S. Martel of McKesson & Robbins, Inc. (one of the editors of this journal), the late Raymond Allen of Mattersdorf & Allen, and Claude Hupp of Glenmore Distilleries Company.

Spearheading this most recent activity by the Controllers Institute National Committee on State and Local Taxation are such industry people as chairman John McFarland of Sun Oil Company, vice chairman Paul A. Reck of Sperry Gyroscope Company, Henry L. Maggiolo of Combustion Engineering, Inc., LaBurne Metzger of Philip Morris, Walter Chwals of U.S. Rubber Company, etc. Assisting them, as legal and technical advisers, are Walter W. Walsh of Chapman, Bryson, Walsh & O'Connell; Leo Mattersdorf of Mattersdorf & Allen; and Frank Snyder of O'Connor & Faber.

In the Council of State Governments is William L. Frederick, Director of Research, and Sidney Spector, who have done an outstanding job for the governors and legislators of the several states, both of whom have directly contributed to the project for uniformity.

These groups believe that the adoption of these recommendations on uniformity of state income taxation would eliminate the possibility of multiple taxation on the same income as well as reduce the administrative burdens to a minimum for both the taxpayer and the state tax administrators. ☆

New California enforcement plan checks federal returns

CALIFORNIA STATE TAX enforcement officials are starting a program of inspection of federal income tax returns of California taxpayers. The new program is expected to yield $4 million from delinquent taxpayers this year.

The new California program involves a comparison of personal federal income tax returns filed in the California offices of the Internal Revenue Service with the state income tax returns. The program now calls for an inspection of only one year's returns, but it is expected to be extended for a total of three years. The estimated expense of the program is $68,000, which is less than 1% of the total expected to be collected. ☆

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

New decisions this month on individual's taxes

Sales representative is employee; Business expenses not deductible. Taxpayer was employed by Eversharp, Inc., during 1948, as supervisor of salesmen in 11 western states and later as sales representative in Michigan. Taxpayer was paid a commission on sales. He was required to devote his full time to company business, to make regular calls on company accounts, submit his proposed itinerary for approval and send in daily performance reports. He could only take orders and could not make collections or adjustments; his territory was restricted; he was subject to the control of a regional manager. The court held that the taxpayer was an employee since he was subject to Eversharp's control and as such could deduct only such expenses as were attributable to "travel, meals, and lodging while away from home." Entertainment, stenographic, telephone, freight, promotional and other expenses were not deductible since the taxpayer had elected to claim the standard deduction. *John A. Radovich*, TCM 1954-220.

Alimony. **(*Acquiescence.*)** Tax Court finds that payments to divorced wife were not alimony but were for release of her interest in former community property. Therefore they are not taxable income to her. *Corinne Pope Thompson*, 22 TC 275, Acq. IRB 1954-47, 5.

Payments under post-divorce agreement deductible. **(*Acquiescence.*)** Taxpayer made periodic payments to his former wife under a pre-divorce settlement which was revised and amended after the divorce but not incorporated in the divorce decree. The payments were held deductible as taking the place of alimony. *Raoul Walsh*, 21 TC 1063, Acq., IRB 1954-48, 6.

Bad debt disallowed: proof not conclusive. Taxpayer's claim of $2,000 nonbusiness bad debt in 1949 was disallowed. Taxpayer referred collection to an attorney in 1948 and 1950 but facts are held insufficient to show that the debt actually became worthless and, if so, in which year. *Emmay Royce*, TCM 1954-207.

Savings Bond interest taxable when bond is redeemed and reissued. The IRS has superseded its prior and more limited ruling and rules now that where a taxpayer redeemed a Series "E" U.S. Savings Bond before maturity and has a new bond issued in the name of his son, interest is taxable at redemption unless the increment in value was previously reported on an accrual basis. *Rev. Rul.* 54-327.

Expense of unused law office disallowed. Taxpayer maintained a law office in his home state during a year in which he was temporarily employed in Washington, D.C. He did not use the office or receive income other than his Washington salary. He kept the office only to maintain good will and for immediate use on his return. He is not permitted to deduct the cost. *Henry G. Owen*, 23 TC No. 46.

Some New Decisions Involving What Is Income

Guggenheim grant held a gift not taxable income. The Court reviews the objectives and methods of the Guggenheim Foundation and concludes that $1,000 paid to taxpayer to supplement his half pay while on sabbatical leave and engaged in research was a nontaxable gift to aid a scholar, not a payment for his services. The Court distinguished *Banks* (17 TC 1386) where Banks was employed by a university for specified work on its research contract with the Navy, and *Robertson* (343 U.S. 711) where the offer of a prize for a symphony was held to be a contract upon taxpayer's entry, so that the consideration was not a gift. Fve judges dissent. *George Winchester Stone, Jr.*, 23 TC No. 37.

Pension payments are income not gifts. Taxpayer by reason of age and length of employment with the state was entitled to payments from the Washington State Retirement Fund far exceeding his contributions thereto. He contends therefore that the difference constituted a gift, not taxable as income. The court held that the legislature was without power to make a gift of state funds and that the payments were in consideration of taxpayer's status as an employee and thus includable in gross income. *Sharpe* v. *U.S.*, DC Wash., 7/30/54.

President's medical expenses, paid by corporation, are income to him. Decedent, 80 at his death, was president and $^1/_7$ owner of a catering corporation, the rest of which was owned by his son and daughter-in-law. In 1950, the corporation paid about $8,700 for the president's medical care. Deduction of this amount was disallowed to the corporation. The Court holds that the payment of these expenses, being in the nature of a bonus for past service, is taxable income to the president. *M. K. Kartsen Estate*, TCM 1954-194.

Food and lodging held compensation. Taxpayer was hired as a radio operator at an Alaskan air base. His employment contract made no mention of subsistence and he did not agree that the value of food and lodging was to be included in his pay. In addition to his salary he received free food (or, at his option, $40 a month) and lodging. The court held that it lacked evidence that food and lodging was provided "for the convenience of the employer" and hence its value must be included in gross income. *Robert Douglas Bartilson*, TCM 1954-218.

Europe not a combat zone; army pay taxable. Europe is not a combat zone. Consequently compensation received by members of the Armed Forces serving in Europe is not exempt. Only Korea is now a combat zone. *Rev. Rul.* 54-517.

Income reconstructed from estimated expenses. Taxpayer reported income from various jobs but not from his poolroom. The Commissioner estimated his total expenditures from weekly estimates made by the taxpayer. Since the taxpayer had no other resources, the Court agrees that the difference should be taxed as income from the business. *Eddie O. Morgan,* TCM 1954-189.

Sister allowed dependency exemption. Taxpayer was one of a household of nine. The court found that the only other regularly employed member of the family was taxpayer's father who claimed and was allowed exemptions for six. Taxpayer claimed two dependents. The court allowed them since it said she paid over half the support of the two. Neither the opinion nor the findings of fact explained how household funds were allocated to support of the various dependents. *Miriam V. Jachens,* TCM 1954-215.

Cousin not a dependent under 1939 code. The taxpayer claimed a dependency credit in that he furnished over $1/2$ the support of his cousin. The court held that a cousin was not a "dependent" as defined for purposes of the 1939 Code but commented that a cousin might qualify as a dependent under the 1954 Code. *Joseph Michael Brown,* TCM 1954-216.

Married son is dependent though he filed a joint 1040A as refund claim. Taxpayer furnished more than 50% of the support of his son and son's wife. The son earned community income of $1,000, regarded as $500 income of each. To secure a refund of tax withheld from his wages, he filed a joint form 1040A. The Service holds that since he was not required to file a return, the 1040A should be regarded as only a refund claim. The father can treat him as a dependent despite the rule that the credit is lost if the dependent files a joint return. *Rev. Rul.* 54-567.

Interest on loan to purchase rental property is a business deduction. Prior to the taxable year, taxpayer borrowed money on unsecured notes to purchase rental property. The court held that interest paid thereon in taxable years is deductible from gross income as a business expense in computing adjusted gross income. Thus it is allowable even though the taxpayer elects the standard deduction. *Koshland* v. *Comm'r.,* CA-9, 11/19/54.

Produce exchange seat is capital asset. The court affirmed a Tax Court holding that a seat on the New York Produce Exchange is a capital asset. Loss on sale is a capital loss. *Cummins* v. *Comm'r.,* CA-2, 11/26/54.

Expense of rented summer cottage. [Acquiescence.] 1947 maintenance expenses of summer cottage used by the taxpayer in 1946 but rented for July and August 1947, were fully allowed on the finding that the conversion to rental use took place in 1946 not July 1, 1947 as contended by Commissioner. *Clarence G. Jones,* 22 TC 407., *Acq.* IRB 1954-47, 5.

Offering for rent or sale does not make residence business property. After 22 years taxpayers, in March 1949, offered their residence for rent or sale and subsequently spent $950 for remodel-

New Decisions on Personal Expenses

Cost of elevator not a medical expense. Taxpayer, on the advice of his doctor following a heart attack, installed an elevator in his home and deducted the cost thereof as a medical expense. The court held that this was not a proper medical deduction. *Jerome W. Benesch,* TCM 154-217.

Travel cost not medical expense of mental patient seeking congenial home. Taxpayer claimed the cost of staying at motels while traveling about the country looking for a more congenial place to live. The advice to find a new home had been given him the year previous by a physician treating him for mental illness. Conceding that it was difficult to draw the line between personal and medical expenses, the Court concluded that relationship between the expenses and the treatment of illness was too remote for the expenses to be allowed. *Gunnar E. Erickson,* TCM 1954-196.

Food, lodging and travel expenses not deductible where employment not temporary. Taxpayer agreed to travel as his employer contracted; he worked at one place for 2 years. The court disallowed deductions for automoblie expenses incurred in visiting his family on week ends and food and lodging during the week, as his employment was not temporary; therefore "home" was at his post of duty. *H. C. Ford,* TCM 1954-209.

Years' job as steamfitter "indeterminate" not "temporary": expenses not deductible. Taxpayer's expenses for food and lodging in Schenectady where he worked for more than a year as steamfitter on a construction project were personal and not deductible as business expense although he expected the duration of employment to be about 6 months and was never informed of the probable duration of the job. *John J. Morley,* TCM 1954-205.

Living expense not allowed construction engineer; job duration was indeterminate; penalty for failure to file estimate. Taxpayer, a civil engineer, was three times during years in question hired by an architectural firm to supervise a particular construction job, and was three times discharged upon completion. The jobs took 3, 18 and 24 months. The court finds the duration was indeterminate; therefore his home was at the job; and rent, food and laundry, etc. there were not deductible. Expense of trips to Florida and Mexico disallowed because connection with business was not shown. The taxpayer claimed reasonable cause for failure to file estimates for 1948 and 1949 in that these expenses had been allowed in prior years, and he always received a refund. He was not excused by filing his 1950 return by January 1, 1951. He had very large other income early in that year and so was liable to file estimates prior to September of the year. Filing the return on 1/15 excuses only those who become liable for estimates after 9/1. [Rules changed under 1954 Code. Ed.] *Walter G. Pauley,* TCM 1954-192.

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ing and repairing the property. No income was realized on the home prior to its sale that November. The loss sustained on sale of the house was ruled a personal loss and not deductible as property had not lost its character as a personal residence. *Samuel A. Coykendall*, TCM 1954-210.

Club not exempt because it had large profits. The club operated a bar and slot machines and produced profit of over $25,000 a year which was used for other activities, insurance fund, and investments. The Court holds that since these profits inured to the benefit of the members the club is not exempt from taxes. *Spokane Commercial Travelers* v. *Squire*, DC Wash., 8/11/54.

Nursery school is educational tax exempt organization. A nursery school which includes in its program routine instruction in organized play, rudimentary skills, and social living maintains a "curriculum" within the meaning of Section 1701 (a) (1) (A) (ii) (educational) of the 1939 Code and is entitled, if other conditions are met, to the exemption from admissions tax provided by that section. *Rev. Rul.* 54-472.

Hotel's contributions to repeal prohibition not deductible. Contributions to the Kansas Legal Control Council in the campaign to repeal prohibition are disallowed because made to an organization attempting to influence legislation. *The Mosby Hotel*, TCM 1954-182.

Deductibility of Contributions

Contribution later transferred to nonexempt fund is donor's income at transfer. A contribution to an exempt organization, subsequently transferred at the request of the donor to a nonexempt fund, constitutes taxable income to the donor for the year of transfer to the extent of the amount previously taken as a deduction. *Rev. Rul.* 54-566.

Contributions to good government league deductible where not engaged in propaganda. [Acquiescence.] Taxpayer, a former mayor of Cincinnati, lawyer and expert on municipal law was very active in civic affairs. For ten years he was president of a local good government league which, while nonpartisan, endorsed political candidates. The court finds that political work for candidates and with legislature, while not requiring much of the league's funds, did constitute a substantial part of its activities. Contributions to it are not deductible as made to an educational organization. However, contributions to the Murray Seasongood Good Government Fund allowed. The Fund made donations to worthy organizations not engaged in attempting to influence legislation. *Murray Seasongood*, 22 TC No. 87, *Acq.*, IRB 1954-47, 5.

Deductions for payments to United Charities Plan. An employee of a corporation having a plan under which it collects funds, by means of voluntary payroll deduction, to be distributed to various designated charities, may enter on his Form 1040 the total amount contributed during any year and the name of the plan, provided he attach a copy of the statement furnished him by the administrators of the plan showing the total amount of his contributions and the percent distributed to each designated organization. *Rev. Rul.* 54-549.

Dues not deductible when privileges are granted. Membership dues paid to a charitable organization are not deductible if the members receive benefits or privileges (*e.g.*, publications, library service, privileges of attending lectures, etc.). In such cases the dues may qualify as business expenses. *Rev. Rul.* 54-565.

Investment trust for charitable foundation is deductible. [Acquiescence.] Taxpayer transferred securities to an irrevocable trust to manage the investments and pay the income to a foundation for social work. The court determined that the gift was in substance to the foundation and its deductibility turns on whether the foundation is exempt under Sec. 101(6). Reviewing its activities, the court finds that its legislative committee was only minor and concerned with state aid for social work and not partisan politics. Deduction allowed. *Martha Hubbard Davis*, 22 TC No. 131, *Acq.*, IRB 1954-49, 6.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Ruling reveals IRS attitude on a foreign subsidiary spin-off exception

by BERNARD J. LONG, *partner*
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REVENUE RULING 54-499 gives us a good insight into the Commissioner's thinking on when he will permit a tax-free reorganization of a foreign corporation.

Prior to the 1932 Revenue Act there was apparently a substantial amount of tax avoidance through the practice of transferring securities which had appreciated in value to foreign corporations in tax-free exchanges or nontaxable reorganizations. The securities would be transferred to a foreign corporation in a country where no tax was imposed on capital gains. Thereafter the securities would be sold and the proceeds held in a foreign corporation or the cash would be transferred to a domestic corporation. Thus tax on the gain could in many cases be completely avoided.

In order to eliminate this method of tax avoidance, Section 112(i) of the 1939 Code was enacted and provided in general that in determining the extent to which gain is to be recognized in the case of certain exchanges which are otherwise generally tax-free exchanges, a foreign corporation would not be considered as a corporation. However, in order to permit the use of tax-free reorganizations in cases where the principal purpose was not the avoidance of federal income taxes, an exception to the general rule was included. Under this exception, the general rule does not apply where prior to the exchange it is established to the satisfaction of the Commissioner that the exchange is not part of a plan to avoid federal income taxes. For most practical purposes, the administrative discretion is complete and the Commissioner must be satisfied before the exception will apply. In unusual cases there may be some recourse to the courts but in most instances the determination of the Commissioner will not be disturbed. [See, *e.g.*, "When Is an Exchange Not the Avoidance of Federal Income Taxes," *Proceedings of N.Y.U. Seventh Annual Institute on Federal Taxation*, p. 1174.]

Revenue Ruling 54-499 points up several factors upon which the Commissioner relied in concluding that the exception was applicable in that particular case. The ruling involves a "spin-off" of stock of a foreign corporation owned by a United States corporation. A U.S. corporation owned about 60% of the total stock of a Canadian corporation. The U.S. company had controlled the Canadian one from its inception. For business and financial reasons it was deemed important to separate the two companies and the plan proposed that a new Canadian corporation be organized and that the U.S. company transfer its stock in the old Canadian company to the new Canadian company for all of the new company's stock. Thereafter the new Canadian stock would be distributed to the U.S. company's stockholders without surrender of any of their stock. The Commissioner determined that:

1. The transaction presented an adequate corporate business purpose for the transfer, exchange, and distribution and was therefore a "reorganization" within the meaning of Section 112(g)(1)(D) of the 1939 Code.

2. The majority stockholders of the U.S. company had no present intention of disposing of their U.S. stock or the new Canadian stock to be received by them, and

3. There was no present intention on the part of the U.S. company to terminate the corporate existence of any of the corporations by liquidation, merger, or otherwise.

4. The transaction was not a plan entered into for the purpose of avoiding federal income tax within the meaning of Section 112(i) of the 1939 Code.

It should be noted that the ruling contains a final *caveat* that it will have no effect in the event the separate corporate existence of any of the three corporations is terminated in any way.

This ruling is significant in that it does demonstrate some of the factors considered by the Commissioner in applying Section 112(i). The ruling has continuing importance since the substance of Section 112(i) of the 1939 Code is retained in Section 367 of the 1954 Code. [For additional comment on this ruling see p. 104.] ☆

New decisions

Recipient of British dividends needs to report only net if he uses standard deduction. British shareholders of British corporations are required for British tax purposes to report as their income the standard surtax paid by the corporation on the dividend. It has been held in the *Biddle* case (302 U.S. 573) that that tax was imposed on the corporation not the shareholder and therefore American shareholders could not add that British tax to their net dividend received and report for U.S. tax purposes the total as income and then claim credit for the foreign tax. However, under the Income Tax Convention, the American shareholder is given an election to report in that way. A taxpayer who elects the standard deduction is not permitted a credit for foreign taxes paid. Such a taxpayer should report as income only the net actually received by him. *Rev. Rul.* 54-533.

Necessity for certificate of compliance by departing alien. Ambassadors, public ministers and other holders of diplomatic passports, together with members of their households, may depart from the U.S. without obtaining (from the District Director of Internal Revenue) a certificate of compliance with income tax laws. Other departing aliens, even though employed by for-

eign governments, must procure such certificates. *Rev. Rul.* 54-551.

No withholding when recipient has U.S. and Puerto-Rican citizenship. Oil and gas royalties derived from U.S. sources by a dual citizen of Puerto Rico and U.S. are not subject to withholding tax. A citizen of Puerto Rico not also a citizen of U.S. will be subject to such tax on determinable periodic income from sources within the U.S. *Rev. Rul.* 54–570.

Philippine exemption of shipping income except coastwise similar to U.S.; Philippine vessels exempt after independence only. The Court agrees with the taxpayer that as a nonresident foreign corporation it is exempt on its earnings from its Philippine-registered vessel on trips to the U.S. The Commissioner had argued that since the Philippines' exemption specifically excluded earnings from Philippine coastwise traffic, and the U.S. exemption did not exclude earnings from U.S. coastwise traffic, the exemptions were not similar and Philippine vessels could not claim U.S. exemption. The Court says it can look at the practical effect of the laws, and notes that by the Merchant Marine Acts foreign-registered vessels are barred from U.S. coastwise shipping. In effect therefore, the U.S. and Philippine exemptions are alike.

However, this exemption is applicable only to foreign corporations and foreign-operated vessels. Until Philippine independence in July 1946, the Philippines were treated, for tax purposes, as a possession and not as a foreign country. Therefore, the exemption applied since July 1946 only. *M/V Nonsuch, Inc.*, 23 TC No. 43.

Penalty for failure to file income report improper despite nonresident's later return to U.S. Taxpayer, with the intention of establishing permanent residence abroad, had gone to France with a job which he expected to last for one year. He planned to seek other employment later. On failure of this plan he returned to the U.S. The Tax Court held that since he was a bona fide resident of France during 1946 with all his income from a source outside the U.S., he had no income which had to be reported and the Commissioner erred in imposing a penalty for failure to file a return. *Elliot D. Sass*, TCM 1954–212.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Changes in D.C. unemployment law may foreshadow changes in other states

PRIOR TO ADJOURNMENT the Congress adopted, over the strenuous objection of national labor unions and the U.S. Labor Department, very substantial changes in the District Unemployment Compensation Law, effective January 1, 1955. Ordinarily changes in the District law would deserve no more prominent mention than changes in any state law. Such is not the case in this instance, however, because of the behind-the-scene developments which were intended to induce the Congress to provide a law which would serve as a model to be followed by the various states. In fact, in signing the bill into law the President himself said, "The Act still is not the model law I should like to see. . . . Defects will be the subject of amendment at the next session of Congress." It appears that the President's advisers were disappointed in the fact that while the amount and duration of benefit were substantially increased, certain disqualification provisions were substantially strengthened. It will be interesting to watch further developments in connection with these amendments. Meanwhile, here are the more prominent features of the changes:

Benefit. The minimum weekly benefit is raised from $6 to $8 and the maximum benefit from $20 to $30 per week. Maximum benefits may be drawn for a period of 26 weeks or until the accumulated benefits equal one-third of the claimant's base wages, whichever amount is the lesser. Thus, the maximum benefit becomes $780 as compared with the maximum of $400 permitted under the old law.

Disqualification. Under the new law an individual who leaves his work voluntarily, is discharged, or refuses suitable work, may be disqualified for not less than four or more than nine weeks in addition to the week in which the work ceased, and the potential benefits of a person so disqualified are cancelled in a sum equal to the weekly benefit amount multiplied by the number of weeks of disqualification. In regard to pregnancy terminations, benefits are eliminated during the six weeks period before and after childbirth. A stringent provision for the forfeiture of benefits in the case of false statements and misrepresentation was added. These new fraud provisions authorize the Board to:

a. disqualify the perpetrator for as long as the balance of his benefit year plus an additional year, and

b. require him to repay fraudulently obtained benefits and either further disqualify him until payment or when he has served his disqualification, credit against his fraudulent benefits any subsequent benefits otherwise obtained until fully offset.

Length of Work Requirement. No minimum period is specified but the amendments require some work in at least two quarters of the base year and the new benefit schedule provides progressively higher minimum qualifying wages for progressively higher benefits.

Minimum Qualifying Wages. The minimum qualifying amount is increased from $150 to $276.

Notification of Payment. The new law requires that the principal base period employer is to be notified of each benefit chargeable to his account at the time of payment.

Miscellaneous. Other changes are:

a. The employer's reserve ratios used to determine his tax rate are reduced .1% in each category.

b. Interest received is now credited to each employer's account at the same rate paid by the federal government on the District Unemployment Compensation Account.

c. Employers are allowed to elect coverage.

d. There is imposed a penalty of 10% of the contribution due in the event the employer fails to file the necessary wage report or pay the contribution when due. ☆

Special ruling holds retired director entitled to OASI benefit

BECAUSE NO GENERAL RULINGS have been released on the question of what is "substantial services" for OASI purposes, we have to content ourselves with those few specific rulings which can be unofficially interpreted as having wider application. The case described below is highly suggestive in an area where a considerable number of retired employees are in a borderline situation.

The amended Social Security Law provides that all earnings whether or not covered by OASI are required to be taken into consideration in applying the retirement test. The retirement test permits all those 65 years of age and less than 72 years of age to earn $1,200 per year without affecting their benefit entitlement. When earnings exceed $1,200 per year, one month's benefits are forfeited for each $80 received in excess of $1,200, providing the individual performed substantial services.

The Internal Revenue Service has held that services rendered by company directors, not employees of the company, are of such a nature that they constitute a "trade or business" and as such are subject to the self-employment tax. Whether a person self-employed and under the age of 72 is precluded from securing social security benefits depends on whether such individual renders substantial services as a self-employed person. The matter of substantial services has not been made the subject of any general ruling. Rather, special rulings are issued only as individuals apply for OASI benefits. The following ruling and factual situation may be of interest to our readers.

An officer of a company retired after being in that company's employ for almost 50 years. Upon retirement he received a pension from a trust fund set up by the company under Section 165(a) of the Code. Following his retirement he continued as a member of the Board of Directors of the company, a member of the Executive Committee, the Stock Option Committee, and the Auditing Committee. In this capacity he attends approximately fifteen meetings per year and receives a $200 fee for attendance at each meeting. In addition, he receives a retainer of $200 per month for holding himself available to the company for consultation and advice. In most months this taxpayer attends only one committee meeting. In some few months he may attend two. He may or may not be contacted by telephone once or twice in a month for consultation purposes. Even in those months when he might attend two meetings, the time devoted to such meeting is estimated to be less than four total hours and not more than a similar number of four hours is likely to be required at any time in preparation for the meeting or in consultation. This individual is not a director of any other company and performs no other services for his former company or any other company.

The Social Security Administration ruled that the individual in these circumstances was entitled to social security benefits for the months involved. Its ruling reads in part as follows:

"As a member of the Board of Directors, an individual is considered to be a self-employed person. The Social Security Act provides that a self-employed person may receive benefits in any month in which he does not render substantial services in pursuance of his trade or business regardless of the amount of his earnings.

"Based upon the facts you have given us, it is our opinion that a member of the Board of Directors who attends only one or two meetings a month, and who devotes no more than approximately eight hours a month to all of his directorial duties is not rendering substantial services and, therefore, is entitled to Social Security benefits for the month involved. This is on the assumption that any consultation or advice given is in connection with his duties as a director." ☆

New payroll decisions this month

Sister working in brother's home for salary is employee. A brother persuaded his sister, who was independent of his financial support, to leave her employment elsewhere and act as housekeeper in his home and companion and nurse to his wife. The sister worked for a salary during regular hours and according to her brother's instructions. This is a bona fide employer-employee relationship, subject to FICA, not a family dependency arrangement. *Rev. Rul.* 54-572.

Owner-driver of laundry truck not employee. Owner-driver of laundry truck who secures his own customers, handles his own accounts, makes his own collections, bears all expenses in connection with the route and retains a percentage of the retail price charged as his remuneration is not an employee of the laundry which services him. His income is subject to self-employment tax. *Rev. Rul.* 54-555.

Employee for federal employment tax is employee for death payment. Where it is determined that a common-law employer-employee relationship exists for federal employment tax purposes it will be considered to exist for determining the exclusion from gross income of payments made on account of the death of the employee under a contract with an employer. *Rev. Rul.* 54-547.

Civilian employees of Army agency are "employees" for FICA. Civilian employees of the Consolidated Nonappropriated Welfare Fund, operated pursuant to Army and Air Force Regulations, will not be considered "employees" for unemployment tax purposes but will be so considered for FICA. *Rev. Rul.* 54-556.

Miscellaneous new decisions this month

Cabaret tax applicable to all payments made by or for persons present during entertainment regardless when payments made. All amounts paid for food, refreshments, etc. by patrons or guests who are present during the time entertainment is afforded, even though the payments are made prior to the commencement of the entertainment, are subject to cabaret tax under Section 1700(e). *Rev. Rul.* 54-487.

Retailers' excise tax due on sales to students. The exemption from retailers' excise tax applies to the sale of toilet preparations to a person operating a school for instruction of students in beauty culture but it does not apply to the sale of such preparations to students of a beauty school or to a motion picture studio. *Rev. Rul.* 54-488.

Tax due on value of articles manufactured for use. A person who manufactures truck bodies for use in the operation of his dairy business incurs liability for manufacturers excise tax on his use of the bodies at the time of use. The tax is computed on the fair market value which is represented by the wholesale price where the manufacturer produces them in volume and regularly sells them at wholesale. Where the article is custom-made the fair market value has been found to represent cost plus 10%. Where a manufacturer believes the facts and circumstances justify a lower tax base the IRS will issue a special ruling upon receipt of a statement as to the facts and circumstances. *Rev. Rul.* 54-490.

Club assessments for improvements and deficits subject to dues tax. Assessments made by a social, athletic or sporting club against its members to pay for capital improvements or to cover current operating deficits constitute "dues or membership fees" within the meaning of Section 1712 of 1939 Code and are subject to taxes due on membership fees under Section 1710 if the total dues or fees, including all assessments, of an active resident annual member are in excess of $10 a year. *Rev. Rul.* 54-504.

Transportation tax due on special unloading when done by carrier; no tax if done by another. When special equipment is used in unloading pipe from railway cars and a special charge is made therefor, transportation tax applies if the charge is made by the carrier. If the work is done by another person (i.e. a trucking company), no tax is due since that person is not engaged in the business of transporting property for hire. *Rev. Rul.* 54-524.

Parent corporation must pay transportation tax on fees to subsidiary for shipping. A subsidiary, in the business of transporting petroleum, also renders this service to its parent. Since parent and subsidiary are separate legal entities, transportation tax is payable on the charge. *Rev. Rul.* 54-541.

Transportation tax on loading freight on pallets. The transportation tax applies to loading of freight on pallets when the service is furnished by the carrier in connection with a taxable transportation movement. Section 143.1 (d) of Regs. 113 defines transportation to include accessorial service such as loading, unloading, blocking, staking, handling and similar services. Loading of freight on pallets is accessorial to the subsequent transportation movement. *Rev. Rul.* 54-476.

Amounts paid for wilful violation of OPA ceiling not deductible as business expense. In 1946 taxpayer claimed a business expense deduction for approximately $35,000 he had paid in satisfaction of a District Court judgment for wilful OPA price ceiling violations. The Tax Court held he could not deduct the payment as a business expense since the District Court had found the violation to be wilful and their determination was res judicata in the Tax Court. *Julian Lentin*, 23 TC No. 16.

Deduction of OPA penalties denied where taxpayer failed to prove they were unintentional. Taxpayer deducted triple OPA damage penalties as a business expense. The District Court denied the deduction on the ground taxpayer had not proved that the evasions were not either wilful or the result of failure to take proper precautions and that allowance of a deduction would frustrate public policy. *Nemrow Bros., Inc.* v. *U.S.*, DC Mass., 10/3/54.

Deduction for OPA violation payments denied where taxpayer failed to prove the violations were not unintentional. A hotel company deducted as ordinary and necessary business expenses the amounts paid to satisfy a judgement for OPA rent and telephone service overcharges. The Tax Court denied the deduction as taxpayer had not proved the acts were unintentional. *Hull Senator Co.*, TCM 1954-185.

OPA settlement not deductible—reasonable care not proved. After a review of the cases, the Court concludes that the proper rule on the deductibility of penalties paid to OPA is: will allowing the deduction frustrate public policy, which means, was the overcharge unintentionally made and not through an unreasonable lack of care? The Court finds the brewery failed to prove this. The overcharge was deliberately made, and this is not excused by the fact that in litigation over the penalty, the lower court (subsequently reversed) held for the brewery. *American Brewery, Incorporated* v. *U.S.*, DC Md., 10/2/54.

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